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SEC Proposes Modernizing Fund Valuation Practices

By [Investment Management Practice](#)

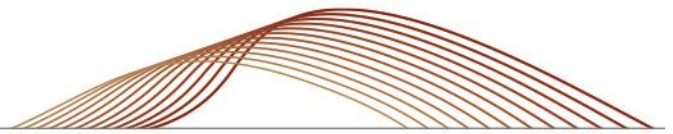
On Tuesday, April 21, 2020, the Securities and Exchange Commission (the “SEC” or the “Commission”), voted to propose a new rule to establish a modern framework for fund valuation practices.¹ The proposed new rule 2a-5 (the “Proposed Rule”) under the Investment Company Act of 1940, as amended (the “1940 Act”) would do the following: (1) establish requirements for determining the fair value in good faith of a fund’s investments; (2) permit boards to assign the fair value determination to a fund’s investment adviser; and (3) define “readily available” market quotations for purposes of the 1940 Act.² The Proposed Rule would extend to all registered investment companies and business development companies (“BDCs”), regardless of their classification or investment objectives or strategies. In the case of a unit investment trust (“UIT”), because there is no board of directors or investment adviser, a UIT’s trustee would conduct fair value determinations under the Proposed Rule.³ It is worth noting that, while the Proposed Rule would apply to registered investment companies, and BDCs, if adopted in current form, private fund advisers, including private equity managers may decide to use the Proposed Rule as a proxy when determining fair valuation for their clients’ investments.

Proposed Rule: Key Takeaways

The Proposed Rule is a result of the Commission’s recognition of the evolution of the markets and fund investment practices since valuation practices under the 1940 Act were last addressed comprehensively in 1969 and 1970. In a statement, the SEC’s Chairman Clayton noted that the Proposed Rule would “improve valuation practices, including oversight, thereby protecting investors and improving market efficiency, integrity, and fairness.”⁴

The following are some of the key takeaways from the Proposed Rule:

1. **Fair Value as Determined in Good Faith.** Fair value as determined in good faith would require (1) assessing and managing material risks associated with fair value determinations, including material conflicts of interest; (2) selecting, applying and testing fair value methodologies; and (3) overseeing and evaluating any pricing services used. The Proposed Rule would also require adopting and implementing written policies and procedures addressing fair value determination, and maintaining certain records.⁵
2. **Who Performs Fair Value Determinations.** The Proposed Rule would confirm that fair value determinations may be made by a fund’s board of directors and would also permit the fund’s board to assign fair value determinations to a fund’s investment adviser, subject to



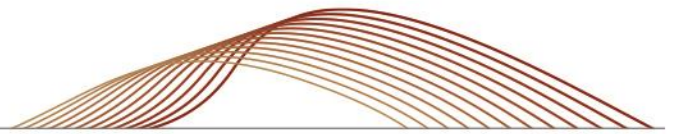
board oversight. This assignment would include periodic reporting to the board, clear specification of responsibilities and reasonable segregation of duties among the adviser's personnel, and keeping additional records relevant to the fair value determinations.⁶

3. **Readily Available Market Quotation.** Under section 2(a)(41) of the 1940 Act, fund investments must be fair valued where market quotations are not "readily available." The Proposed Rule would clarify that the definition of "readily available" is triggered only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date. Under the Proposed Rule, "valuated prices", "indications of interest" and "accommodation quotes" would not be "readily available" market quotations.⁷ As an example, the Proposing Release notes that if a fund invests in securities that trade in foreign markets, the board or adviser generally should identify and monitor for the kinds of significant events that, if they occurred after the market closes in the relevant jurisdiction but before the fund prices its shares, would materially affect the value of the security and therefore may suggest that market quotations are not reliable.⁸

Determination of Fair Value

The Proposed Rule would provide requirements for determining fair value in good faith with respect to a fund for purposes of section 2(a)(41) of the 1940 Act and rule 2a-4 thereunder. In order to determine fair value, the Proposed Rule outlines the required functions that must be performed in order to determine in good faith the fair value of a fund's investments. The required functions are:

1. **Valuation Risks** – The Proposed Rule would require the periodic assessment of any material risks associated with fair valuing investments, including material conflicts of interest, and managing identified valuation risks;
 - The Proposing Release notes that there are many potential sources of valuation risk and some of those are:
 - the types of investments held or intended to be held by a fund;
 - potential market or sector shocks or dislocations;⁹
 - the extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by an adviser;
 - the proportion of a fund's investments that are fair valued as determined in good faith and their contribution to the fund's returns;
 - reliance on service providers that have more limited expertise in relevant asset classes; the use of fair value methodologies that rely on inputs from third-party service providers; and the extent to which third-party service providers rely on their own service providers (so-called "fourth-party" risks); and
 - the risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.
2. **Fair Value Methodologies** – The Proposed Rule would require selecting and applying, in a consistent manner, an appropriate methodology or methodologies for determining fair value of fund investments by specifying:



- the key inputs and assumptions¹⁰ specific to each asset class or portfolio holding; and
- the methodologies that will apply to new types of investments that a fund intends to invest.

The Proposed Rule also would require the selected methodologies to be periodically reviewed for appropriateness and accuracy, and to be adjusted, if necessary.¹¹ The Proposing Release notes that selecting and applying a methodology consistently and reviewing the methodology and adjusting it if necessary are all important elements to determining fair value in good faith. The reason for this is that an inappropriate methodology, or a methodology that is applied inconsistently, increases the likelihood that a fund's investments will be improperly valued.¹²

The Proposing Release further notes that to be appropriate under the Proposed Rule, and in accordance with current accounting standards, a methodology used for purposes of determining fair value must be consistent with ASC Topic 820, and thus derived from one of the approaches outlined in ASC Topic 820.¹³ However, the SEC acknowledges that there is no single methodology for determining the fair value of an investment "because fair value depends on the facts and circumstance of each investment, including the relevant market and market participants."¹⁴ The Commission further points out that in order to be consistent with the principles in ASC Topic 820, under the Proposal Rule, the methodologies selected should maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

3. *Testing of Fair Value Methodologies* – The Proposed Rule would require the testing of the appropriateness and accuracy of the methodologies used to calculate fair value by identifying:
 - the testing method for valuation to be used; and
 - the minimum frequency of that testing.

The Proposing release notes that "calibration"¹⁵ can assist in assessing whether a fund's valuation technique reflects current market conditions, and also whether any adjustments to the valuation technique are appropriate.

4. *Pricing Services* – The Proposed Rule would require the approval, monitoring, and evaluation of third-party pricing services, when used. The Proposing Release notes that a board or an adviser should take into account the following considerations when approving, monitoring, and evaluating a pricing service provider:
 - the qualifications, experience, and history of the pricing service;
 - the valuation methods or techniques, inputs, and assumptions used by the pricing service for different classes of holdings, and how they are affected as market conditions change;
 - the pricing service's process for considering price "challenges," including how the pricing service incorporates information received from pricing challenges into its pricing information;



- the pricing service’s potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts;
 - the testing processes used by the pricing service.¹⁶
5. *Fair Value Policies and Procedures* – The Proposed Rule would require written policies and procedures addressing the determination of the fair value of a fund’s investments. The Proposing Release notes that where the board assigns fair value determinations to a fund’s 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 1940 Act.
6. *Recordkeeping* – The Proposed Rule would require that a fund maintain:
- documentation to support fair value determinations for at least five years, and the first two years in an easily accessible place; and
 - a copy of policies and procedures that were in effect at any time within the past five years, in an easily accessible place.

Performance of Fair Value Determinations

The Proposed Rule would permit a fund’s board of directors to assign the fair value determination relating to any or all fund investments to a fund’s investment adviser, which would carry out all of the functions required in paragraph (a) of the Proposed Rule, subject to certain requirements, including board oversight.¹⁷ A fund’s board that determines to assign fair value determination may assign such determinations to a fund’s primary adviser or one or more sub-advisers. The Proposing Release notes that for a fund with a sub-adviser responsible for managing a portion of the fund’s portfolio, the board could assign the determination of fair value for the investments in that portion of the fund’s portfolio to that sub-adviser. Thus, a fund with a multi-manager structure could have multiple advisers assigned the role of determining fair value of the different investments that those advisers manage.

If a board decides to assign fair value determinations to the fund’s adviser then assignment under the Proposed Rule would be subject to board oversight and certain reporting, recordkeeping, and other requirements designed to facilitate the board’s ability effectively to oversee the adviser’s fair value determinations. It is worthwhile to note that in her public statement on the Proposed Rule, Commissioner Hester Peirce noted that “a fund board that chooses to assign fair valuation duties to its adviser ... would be bound by specific requirements as to how to oversee its adviser...”¹⁸ Commissioner Peirce further noted, “[w]hy is this level of prescription necessary? Boards are perfectly able to ensure that they have a full picture of their advisers’ valuation activities without the Commission imposing a series of one-size-fits-all requirements in a new regulation.”¹⁹ It is also our observation that the requirements to oversee the adviser and receive certain reporting from the adviser on fair value determinations seem to be inconsistent with recent Commission actions designed to modernize the regulatory responsibilities of fund directors.²⁰ In fact, Dalia Blass, Director of Division of Investment Management, has noted that the “list of responsibilities has grown significantly in 77 years” for fund boards.²¹ And if adopted as proposed, these additional requirements may unnecessarily add to the list of responsibilities.

If a Board decides to assign fair value determination to the fund’s adviser then the following requirements must be adhered to:

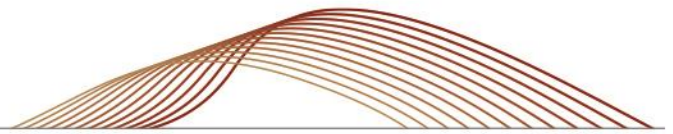


1. *Board Oversight* – the Proposing Release notes that where a board assigns fair value determinations to a fund’s adviser, the Proposed Rule would require the board to satisfy its statutory obligation with respect to such determinations by overseeing the adviser. The Proposing Release further notes that effective oversight cannot be a passive activity and fund directors should ask questions and seek relevant information. In addition, oversight should be an iterative process and seek to identify potential issues and opportunities to improve the fund’s fair value processes. The Proposing Release does acknowledge that the level of board oversight will vary by fund. For example, a board’s scrutiny would likely be different if a fund invests in publicly traded foreign companies than if the fund invests in private early stage companies. As the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, the Commission would expect that the board’s level of scrutiny would increase correspondingly.

Boards would also be required to take reasonable steps to manage conflicts of interest associated with adviser’s fair value determinations. The Proposing Release notes that a board should serve as a meaningful check on the conflicts of interest of the adviser and other service providers involved in the determination of fair values. Specifically, a fund’s adviser may have 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.²²

In addition, Boards would also need to consider the type, content, and frequency of the reports they receive from the fund’s adviser. The Proposed Rule would require reporting to the board (both periodically and promptly) regarding many aspects of the adviser’s fair value determination process as a means of facilitating the board’s oversight. While a board would be able to rely on the information provided to it in summaries and other materials provided by the adviser and other service providers in conducting its oversight, the Proposing Release notes that “it is incumbent on the board to 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.”²³ Further, the Proposing Release notes that if a board becomes aware of material matters (whether the board identifies the matter itself or the fund’s CCO or adviser or another party identifies the issue), in order to fulfill its oversight duty the board would need to inquire about such matters and take reasonable steps to see that they are addressed.

2. *Board Reporting* – Boards would be required certain periodic and prompt reporting:
 - Periodic Reporting: The Proposed Rule 2a-5 would require a fund’s adviser, at least quarterly, to provide the board a written assessment of the adequacy and effectiveness of the adviser’s process for determining the fair value of the assigned portfolio of investments. The periodic reports would be required to, at a minimum, include a summary or description of the following information:
 - Material Valuation Risks. The assessment and management of material valuation risks that would be required under the Proposed Rule.
 - Material Changes to or Material Deviations from Methodologies. Any material changes to, or material deviations from, the fair value methodologies established under the Proposed Rule.



- Testing Results. The results of any testing of fair value methodologies as part of the required fair value policies and procedures.
- Resources. The adequacy of resources allocated to the process for determining the fair value of the fund's assigned investments, including any material changes to the roles or functions of the persons responsible for determining the fair value.
- Pricing Services. Any material changes to an adviser's process for overseeing pricing services, as well as any material events related to its oversight of such services, such as changes of service providers used or price overrides.
- Other Requested Information. Any other materials requested by the board related to an adviser's process for determining the fair value of fund investments.

It is important to note that the foregoing information is not the only information that can be considered by a board and the board could review and consider certain other information as noted in the Proposing Release.²⁴

- Prompt Board Reporting: The Proposed Rule would require that an adviser promptly report to a board in writing on matters associated with the adviser's process that *materially affect, or could have materially affected*,²⁵ the fair value of the assigned portfolio of investments, including a significant deficiency or a material weakness in the design or implementation of the adviser's fair value determination process or material changes in the fund's valuation risks.
3. *Specification of Functions* – The Proposing Release notes that if a board assigns the fair value determination requirements for one or more fund investments to an adviser, the Proposed Rule would require the adviser to specify the titles of the persons responsible for determining the fair value of the assigned investments, including by specifying the particular functions for which the persons identified are responsible. The Proposing Release also specifically notes that the Proposed Rule would require a fund's adviser to reasonably segregate the process of making fair value determinations from the portfolio management of the fund because the the Commission views portfolio managers or persons in related functions that have input in the design or modification of fair value methodologies, or in the calculation of specific fair values as a potential source that may lead to conflicts of interest in the fair value determination process.
 4. *Records of Assignment* – Under the Proposed Rule, a fund must also keep records related to the fair value determinations assigned to the adviser. Specifically, the fund would be required to keep:
 - copies of the reports and other information provided to a board required by the Proposed Rule and
 - a specified list of the investments or investment types whose fair value determinations have been assigned to an adviser pursuant to the requirements of the Proposed Rule.



Readily Available Market Quotations

The Proposed Rule would provide that a market quotation is readily available for purposes of section 2(a)(41) of the 1940 Act with respect to an investment only when that quotation is a quoted price (unadjusted) in active markets for identical investments that a fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable. Under the Proposed Rule a quote would be considered unreliable 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.²⁶ For example, the Proposing Release notes that under current U.S. GAAP, funds looking to the Proposed Rule would use previous closing prices for securities that principally trade on a closed foreign market to calculate the value of that security, except when an event has occurred since the time the value was established that is likely to have resulted in a change in such value. In such circumstances, a fund would need to fair value the security.

Rescission of Prior Commission Releases

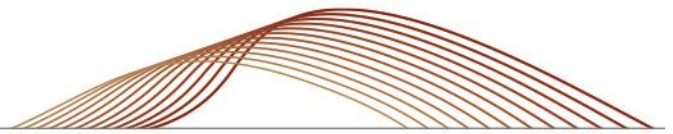
In connection with the Proposed Rule, the Commission also proposed rescinding two previous releases on fund valuation, Accounting, Series Release 113 (ASR 113) and Accounting Series Release 118 (ASR 118),²⁷ which are currently relied upon to determine the fair value for restricted securities. Additionally, the Proposed Rule addressed that certain staff letters and staff guidance may be rescinded if the Proposed Rule is adopted.²⁸

Proposed Transition Period

The Commission is proposing a one-year transition period for funds to prepare for compliance with the Proposed Rule. This transition period would begin after publication of the final rule in the Federal Register.²⁹

The Commission will accept public comments on the Proposed Rule until July 21, 2020.³⁰ The Proposed Rule is available at <https://www.sec.gov/rules/proposed/2020/ic-33845.pdf>.

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¹ Good Faith Determinations of Fair Value, SEC Release No. IC-33845; File No. S7-07-20, available at <https://www.sec.gov/rules/proposed/2020/ic-33845.pdf> (April 21, 2020) (the “Proposing Release”).

² SEC Proposes to Modernize Framework for Fund Valuation Practices (the “SEC Statement”), SEC, available at <https://www.sec.gov/news/press-release/2020-93> (April 21, 2020).

³ *Proposing Release* at 16.

⁴ *SEC Statement* at 1.

⁵ *Proposing Release* at 21.

⁶ *SEC Statement* at 1.

⁷ *Id.* at 59.

⁸ *Id.* at 20-21.

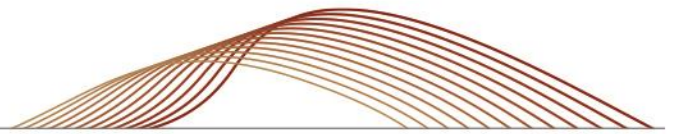
⁹ *Id.* at 17 n.42. (Potential indicators of market or sector shocks or dislocations could include a significant change in short-term volatility or market liquidity, significant changes in trading volume, or a sudden increase in trading Suspensions).

¹⁰ *Id.* at 19 n.45. (Regarding the key inputs and assumptions specific to each asset class or portfolio holding, the *Proposing Release* notes that it would not be sufficient, for example, to simply state that private equity investments are valued using a discounted cash flow model, or that options are valued using a Black-Scholes model, without providing any additional detail on the specific qualitative and quantitative factors to be considered, the sources of the methodology’s inputs and assumptions, and a description of how the calculation is to be performed (which may, but need not necessarily, take the form of a formula)).

¹¹ *Id.* at 21 n.50. (ASC Topic 820-10-35-25 provides a non-exhaustive list of events that may warrant a change or an adjustment to a valuation technique, including where (1) new markets develop, (2) new information becomes available, (3) information previously used is no longer available, (4) the valuation technique improves, and (5) market conditions change. The *Proposing Release* notes that boards or advisers generally should seek to account for such occurrences and consider specifying alternative sources).

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- ¹² *Id.* at 19-20.
- ¹³ *Id.* at 19 n.44. (ASC Topic 820 refers to valuation approaches, including the market approach, income approach, and cost approach, as well as valuation techniques and methods as ways in which to measure fair value).
- ¹⁴ *Id.* at 20.
- ¹⁵ *Id.* at 23 n.57. (The Proposing Release defines “calibration” 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 Act and the prices calculated for those holdings by the fund’s fair value methodology at the time of acquisition).
- ¹⁶ *Id.* at 25 n.62.
- ¹⁷ *Id.* at 32. (A board, if it so desires, may choose to determine fair value in good faith for any or all fund investments by carrying out all of the functions required in paragraph (a) of the Proposed Rule, including, among other things, monitoring for circumstances that necessitate fair value, selecting valuation methodologies, and applying those methodologies).
- ¹⁸ See Hester M. Peirce, Statement on Good Faith Determinations of Fair Value under the Investment Company Act of 1940 Proposal (Apr. 21, 2020), <https://www.sec.gov/news/public-statement/statement-peirce-fair-value-2020-04-21>.
- ¹⁹ *Id.*
- ²⁰ Independent Directors Council, SEC Staff No-Action Letter (Oct. 12, 2018); Independent Directors Council, SEC Staff No-Action Letter (Feb. 28, 2019).
- ²¹ Dalia Blass, Keynote Address: ICI Securities Law Developments Conference (Dec. 7, 2017), available at <https://www.sec.gov/news/speech/bllass-keynote-icisecurities-law-developments-conference-2017>.
- ²² Proposing Release at 36.
- ²³ *Id.* at 37.
- ²⁴ See *Id.* at 45-47.
- ²⁵ *Id.* at 49. (The Proposing Release notes that “could have materially affected” is intended to capture certain circumstances where, for example, 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 affected the larger assigned portfolio of investments or some subset of that portfolio).
- ²⁶ *Id.* at 58.
- ²⁷ *Id.* at 60-61.
- ²⁸ *Id.* at 66-67.
- ²⁹ *Id.* at 67.
- ³⁰ *Id.* at 2.