

May 6, 2020

SEC Proposes Rule Permitting Boards to Assign Fair Valuation to Fund Advisers

On April 21, 2020, the SEC issued [a release](#) containing proposed Rule 2a-5 (the “Rule”) under the 1940 Act (the “proposing release”). The Rule is intended to “address valuation practices and the role of the board of directors with respect to the fair value of the investments of a registered investment company or business development company.” If the Rule is adopted, the SEC plans to rescind previously issued guidance on the role of a fund’s board in determining fair values. The Rule also would mandate more specific fair value practices, policies and procedures, reporting, and recordkeeping requirements. Most notably:

- The Rule would permit a fund’s board¹ to formally assign fair value determinations to the fund’s investment adviser.
- If a fund’s board formally assigns fair value determinations to a fund’s investment adviser, the investment adviser would be subject to board oversight and detailed reporting, recordkeeping and other requirements intended to enhance the board’s oversight of the investment adviser’s fair value determinations.
- Regardless of whether a fund’s board assigns fair value determinations to a fund’s investment adviser, the Rule would prescribe detailed requirements for determining fair values.
- The Rule would define the criteria for concluding that a market quotation is “readily available,” which is currently undefined in the 1940 Act and the rules thereunder.

Summary of the Rule

Requirements to Determine Fair Values. The Rule provides that the overall program used to determine the fair value of a fund’s portfolio investments must include:

1. Assessing and managing material risks associated with fair value determinations;
2. Selecting, applying and periodically assessing fair value methodologies;
3. Testing the appropriateness and accuracy of the fair value methodologies that have been selected;
4. Overseeing and evaluating any pricing services used;
5. Adopting and implementing policies and procedures reasonably designed to achieve compliance with the requirements of Items (1) – (4); and
6. Maintaining documentation to support fair value determinations, including information regarding the specific methodologies applied and the assumptions and inputs considered.

¹ The Rule provides that “board” means either the fund’s entire board of directors/trustees or a designated committee composed of a majority of directors/trustees who are not interested persons of the fund.

If a board assigns a fund's fair value determinations to the fund's investment adviser (which may include any sub-adviser that manages the fund or a portion thereof), the Rule would require the investment adviser to (a) perform the functions listed in Items 1 – 5 above and (b) ensure that the documentation specified in Item 6 is maintained by the fund.² In addition, the Rule would subject the adviser to the board oversight and reporting requirements described below.

Oversight and Reporting. The Rule would require the board to oversee the investment adviser with respect to its fair value determinations, and the investment adviser would be required to:

1. Inform the board in writing of the titles of the persons responsible for determining the fair value of the fund's portfolio holdings, including the particular functions for which they are responsible;
2. Reasonably segregate the fair valuation process from the fund's portfolio management;
3. At least quarterly, provide a written report to the fund's board containing an assessment of the adequacy and effectiveness of the investment adviser's process for determining the fair value of the fund's portfolio investments, including any material changes to the roles or functions of the persons responsible for determining the fair value of the fund's portfolio investments;
4. Report to the board in writing promptly on matters (in no event later than three business days after the adviser becomes aware of the matter) associated with the investment adviser's fair valuation process that materially affect, or could have materially affected, the fair value of the fund's investments;³ and
5. Maintain, in addition to the documentation specified in Item 6 above, the reports and other information provided to the board and a list of the investments whose fair value was determined by the investment adviser.

Definition of “Readily Available.” Under Section 2(a)(41) of the 1940 Act, if a market quotation is “readily available” for a portfolio holding, it must be valued at its market value. If market quotations are not readily available, a holding's value is its “fair value as determined in good faith by the board.” However, the term “readily available” is currently not defined under the 1940 Act or rules thereunder.

To fill this gap, the Rule would provide:

For purposes of section 2(a)(41) . . . 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, provided that a quotation will not be readily available if it is not reliable.

Elaborating on the SEC's analysis, the proposing release states:

[The SEC] believes that for a fair value methodology to be appropriate under the proposed rule, it must be determined in accordance with U.S. GAAP . . . U.S. GAAP requires funds to maximize the use of relevant observable inputs and minimize the use of unobservable inputs. However, under U.S. GAAP there are circumstances where otherwise relevant observable inputs become unreliable [citing ASC Topic 820⁴]. Consistent

² If a fund's board does not assign fair value determinations to the fund's investment adviser, the Rule would require the fund to adopt and implement the policies and procedures required under Item 5 and to maintain the records required by Item 6. In this Alert, we assume that the fund's board has assigned the fund's fair value determinations to its investment adviser.

³ Regarding the “promptly” requirement, in the proposing release, the SEC recognized 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.”

⁴ In the proposing release, the SEC also states: “ASC Topic 820 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. [GAAP].”

with this, **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. (Footnote omitted and emphasis added).

Thus, for purposes of the Rule, whether a quotation is “reliable” would turn on existing U.S. GAAP. Specifically, the Rule would equate the determination that market quotations are “not readily available” with the determination under U.S. GAAP that “otherwise relevant observable inputs become unreliable.”

Observations

1. The Rule’s authorization of board assignment of fair valuation responsibilities is not surprising in view of the fact that most fund directors do not have the technical expertise and daily involvement to contemporaneously determine the fair values of fund portfolio holdings. The proposing release notes that, “typically, boards determine the methodologies used to fair value fund investments, but rely on the adviser for the day-to-day calculation of fair values.” Therefore, the Rule’s key provision – permitting a fund’s board to assign fair value determinations to the fund’s investment adviser – may more closely reflect current practice than does the SEC’s 2014 position that a fund’s board may not delegate the determination of fair values.⁵ Word choice aside, the Rule’s *express* permission to assign will be welcomed by fund boards.
2. The Rule’s use of the term “assign” (“board may choose to assign the fair value determination”) instead of “delegate” appears intentional. In the 2014 Money Market Reform Release the SEC stated:

We note that a fund’s board of directors has a **non-delegable responsibility** to determine whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund’s portfolio security. (Emphasis added).

The SEC’s word choice seems designed to avoid a potential conflict with its prior “non-delegable” articulation of a board’s duty.

3. The Rule’s structure is familiar. The SEC’s liquidity risk management rule (Rule 22e-4) requires a fund’s liquidity risk management program to have an administrator, and the SEC’s re-proposed derivatives rule (Rule 18f-4) would require a fund’s derivatives risk management program to have a derivatives risk manager. The Rule tracks this structure by (i) specifying in detail the elements required to be part of an investment adviser’s fair valuation program and (ii) requiring the investment adviser to specify “the titles of the persons responsible for determining the fair value of the assigned investments, including specifying the particular functions for which they are responsible.” A notable difference, however, is that the Rule does not assign a title to these “persons responsible.”
4. The Rule requires that an investment adviser “reasonably segregates the process of making fair value determinations from the portfolio management of the fund.” While the Rule does not elaborate on what constitutes reasonable segregation, the proposing release states (a) the reasonable segregation requirement does not mean that portfolio management must necessarily be subject to a communications “firewall,” and (b) the SEC recognizes that portfolio management can provide “important perspective and insight regarding the value of fund holdings.” Thus, according to the proposing release, the “reasonable segregation requirement is designed to help reduce and manage potential conflicts of interest” while permitting funds to determine “their fair value

⁵ See Money Market Fund Reform; Amendments to Form PF, Rel. No. IC-31166 (July 23, 2014) (the “Money Market Reform Release”).

determination process and portfolio management functions in ways that are tailored to each fund's facts and circumstances."

5. The Rule is very prescriptive regarding the frequency and nature of an investment adviser's reports to a fund's board, which must contain an "assessment of the adequacy and effectiveness of the investment adviser's process for determining the fair value" of the fund's investments. In a public statement regarding the Rule's proposal, Commissioner Peirce acknowledged the benefits of boards assigning fair value determinations to investment advisers, but she also stated her concern that these "benefits may be diminished significantly by an overly prescriptive approach to ensuring adequate board administration of the fair valuation process." In a similar vein, the SEC stated that the Rule would differ from the current regulatory framework because "it would mandate more specific fair value practices, policies and procedures, reporting, and recordkeeping requirements and those requirements would be explicitly imposed on funds and performed by boards or advisers." Therefore, we expect the industry comments submitted to the SEC will emphasize the costs of implementing (and, then, complying with) the Rule, and the fact that these costs will be passed on to investors.

Public Comments

Comments on the Rule must be received by the SEC no later than **July 21, 2020**.

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