

Legal Update

SEC Proposes Valuation Rule for Registered Funds

On April 21, 2020, the US Securities and Exchange Commission (“SEC”) proposed new rule 2a-5 under the Investment Company Act of 1940, as amended (the “Investment Company Act”), which is intended to address valuation practices and the role of the board of directors with respect to the fair value of the investments of an investment company or business development company registered under the Investment Company Act (each, a “fund”).¹ Specifically, proposed rule 2a-5 would establish requirements in connection with the determination of fair value in good faith of fund investments for purposes of Section 2(a)(41) of the Investment Company Act, as well as permit a fund’s board of directors to assign this fair value determination to the fund’s investment adviser, subject to board oversight and certain other conditions.² Proposed rule 2a-5 also provides a proposed definition of a “readily available” market quotation for purposes of the Investment Company Act.

The SEC noted in the Proposal Release that there have been significant developments in fund valuation practices since the SEC last comprehensively addressed valuation under the Investment Company Act in a pair of Accounting Series Releases in 1969 and 1970 (ASR 113 and 118) and that proposed rule 2a-5 is meant to establish a “consistent framework for fair value and standard of baseline practices across funds.”³ This Legal Update highlights and describes the key requirements under the SEC’s proposed fund valuation rule.

A. Determining Fair Value in Good Faith

In order to determine fair value in good faith for purposes of Section 2(a)(41) of the Investment Company Act, proposed rule 2a-5 would require a fund to perform the following specified functions.

- 1) **Assess and Manage Valuation Risks.** Funds would be required to periodically assess material risks associated with the fair value determination of fund investments (collectively, “valuation risks”), including material conflicts of interest, and to manage such identified valuation risks. The SEC noted that its belief that assessing and managing identified valuation risks is an important element for determining fair value in good faith because ineffectively managed valuation risks can make it more likely that a fund board or a fund investment adviser may incorrectly value an investment.⁴
- 2) **Establish and Apply Fair Value Methodologies.** Under the proposed rule, funds would be required to select and apply in a consistent manner an appropriate methodology or methodologies for determining (which includes calculating) the fair value of fund investments,

including specifying (1) the key inputs and assumptions specific to each asset class or portfolio holding and (2) the methodologies that will apply to new types of investments in which the fund intends to invest. The SEC indicated in the Proposal Release that these fair value methodologies must be consistent with ASC Topic 820 and US GAAP in order to be appropriate under proposed rule 2a-5, but noted 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.” The proposed rule also would require the selected methodologies to be periodically reviewed for appropriateness and accuracy and to be adjusted if necessary. Under proposed rule 2a-5, funds also would be required to monitor for circumstances that may necessitate the use of fair value and to establish criteria for determining when market quotations are no longer reliable.⁵

- 3) **Perform Testing of Fair Value Methodologies.** Under proposed rule 2a-5, funds would be required to test 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. The SEC stated in the Proposal Release that the manner and frequency of such testing are matters that depend on the circumstances of each fund and thus should be determined by the relevant fund’s board or adviser but noted its belief that back-testing could be potentially useful in identifying trends as well as potentially assisting such fund or adviser in identifying issues with methodologies applied by fund service providers, including poor performance or potential conflicts of interest.⁶
- 4) **Establishing a Process for Evaluating Pricing Service Providers.** Funds would be required under proposed rule 2a-5 to oversee any pricing service providers used in the fund valuation process and would need to establish a process for the approval, monitoring, and evaluation of each pricing service provider as well as the criteria for initiating price challenges (e.g., establishing objective thresholds).⁷
- 5) **Fair Value Policies and Procedures.** Funds would be required to adopt and implement written fair valuation policies and procedures approved by the fund’s board that are reasonably designed to achieve compliance with the above requirements. Should the board assign fair value determinations to the fund’s investment adviser (see below), these fair value policies and procedures would be adopted and implemented by the adviser, subject to board oversight under Rule 38a-1.⁸
- 6) **Recordkeeping.** In addition to maintaining copies of the above fair value policies and procedures, funds would be required to maintain 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.⁹

B. Performance of Fair Value Determinations

While the SEC historically has taken the position that a fund’s board may not delegate the determination of the fair value with respect to the fund’s investment, the SEC recognized in the Proposal Release that most funds’ board of directors do not play a day-to-day role in the pricing and valuation of fund investments and often depend on the specialized expertise and resources of the fund’s investment adviser to assist in the determination of the fair value of fund investments.

Therefore, proposed rule 2a-5 would formally permit a fund's board of directors to assign the determination of the fair value of the fund's investments to the fund's investment adviser, subject to supervision and oversight by the fund's board.¹⁰ The SEC noted that such approach is designed to "provide boards and advisers with a consistent, modern approach to the allocation of fair value functions, while also preserving a crucial role for boards to fulfill their obligations under Section 2(a)(41) of the Investment Company Act."¹¹

Under proposed rule 2a-5, a fund's board may assign to the investment adviser the fair value determination functions described above in Section A provided that certain additional oversight requirements are also met. First, the fund's board of directors would be required to oversee the adviser's handling of such fair value determinations. In describing this element, the SEC noted that fund boards should approach this oversight role with a "skeptical and objective view that takes account of the fund's particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determination process, and the skill and resources devoted to it" and not as a "passive activity."¹² In addition, advisers that are assigned such fair value functions would be required to:

- Provide, at least quarterly, an assessment of the adequacy and effectiveness of the adviser's process for determining the fair value of the fund's investments;¹³
- Report promptly to the fund's board, no later than three business days after the adviser becomes aware of the matter, matters associated with the adviser's process that materially affect or could have materially affected the fair value of the fund's investments (including a significant deficiency or material weakness in the design or implementation of the adviser's fair value determination process or material changes in the fund's valuation risks); and
- Specify the titles of the persons responsible for determining the fair value of the fund's investments (including the particular functions for which such personnel are responsible) as well as reasonably segregate the process of making fair value determinations from the portfolio management of the fund. With regard to the latter, the SEC noted that such "reasonable" segregation of functions would be "tailored to each fund's facts and circumstances, including the size and resources of the fund's adviser." The SEC further explained that this reasonable segregation requirement is not meant to necessarily prevent portfolio managers from providing inputs that are used in the fair value determination process but to help reduce and manage potential conflicts of interest.¹⁴

Funds would also be required to maintain copies of the reports and other information provided to the board and a specified list of the investments or investment types whose fair value determination has been assigned to the adviser, in each case for at least five years after the end of the fiscal year in which the documents were provided to the board or the investments or investment types were assigned to the adviser.¹⁵

C. Readily Available Market Quotations

Under the Investment Company Act, fund investments must be fair valued where market quotations are not "readily available." Proposed rule 2a-5 would treat a market quotation as "readily available" for purposes of Section 2(a)(41) of the Investment Company Act 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.¹⁶ The SEC noted in the Proposal Release that a quote would be considered unreliable and must be fair valued

under proposed rule 2a-5(c) in the same circumstances where it would require adjustment under US GAAP or where US GAAP would require consideration of additional inputs in determining the value of the security. The SEC also noted in the Proposal Release that evaluated prices are not, by themselves, “readily available” market quotations and that “indications of interest” and “accommodation quotes” would also not be considered “readily available” market quotations for purposes of proposed rule 2a-5.¹⁷

D. Rescission of Prior Commission Releases and Review of Relevant Staff Guidance; Transitional Compliance Date

In view of the proposal’s modernized approach to fund valuation, the SEC indicated in the Proposal Release that it intends to rescind ASC 113 and 118 as well as rescind or withdraw certain SEC staff letters and other staff guidance addressing fund valuation matters in connection with any adoption of final version of rule 2a-5, noting that these letters and guidance (or portions thereof) would be moot, superseded, or otherwise inconsistent with the final rule and, therefore, would need to be withdrawn or rescinded. The Proposal Release also stated that the SEC is proposing a one-year transition period to provide time for funds and their advisers to prepare to come into compliance with proposed rule 2a-5 and that, if adopted, the proposed effective date of the rule would be one year following the publication of the final rule in the *Federal Register*.¹⁸

E. Conclusion

The industry has waited a long time for the SEC to take formal action to provide further guidance on fund valuation matters, and the Proposal Release is an important first step in that direction. On the whole, we view the proposed rule as mostly formalizing or expanding on existing industry practices rather than blazing a completely new trail. However, as the SEC noted in the Proposal Release, the proposed rule would differ from the current and more flexible regulatory framework by imposing more specific fair value practices, policies and procedures, reporting, and recordkeeping requirements that would need to be adopted by funds should the rule be finalized.¹⁹ In addition, the proposed ability for fund boards to formally assign fair valuation to fund advisers and the associated conditions to such assignment is a noteworthy element that most fund complexes will likely review closely in evaluating the proposal.

The public is invited to submit comments regarding proposed rule 2a-5 until July 21, 2020. If you have any questions regarding the proposal or wish to submit comments, please contact the authors below or any other members of our Investment Management group.

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Endnotes

- 1 Good Faith Determinations of Fair Value, Investment Company Act Release No. 33845 (April 21, 2020), *available at* <https://www.sec.gov/rules/proposed/2020/ic-33845.pdf> (the "Proposal Release").
- 2 The Investment Company Act requires funds to value their portfolio investments by 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 of directors. See Section 2(a)(41) of the Investment Company Act and rule 2a-4 thereunder.
- 3 In the Proposal Release, the SEC stated that it 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") and that fund valuation practices has significantly evolved since then, including (among other things), (i) the enactment of the Sarbanes-Oxley Act of 2002, which led to the adopting of rule 30a-3 under the Investment Company Act (requiring disclosure controls and procedures and internal control over financial reporting); (ii) the compliance program rule (rule 38a-1 under the Investment Company Act), which required funds to adopt and maintain written compliance policies and procedures (including those related to fair valuation); and (iii) the issuance of ASC Topic 820 by the Financial Accounting Standards Board in 2006 and 2009, which defined the term "fair value" for purposes of the accounting standards and established a framework for the recognition, measurement, and disclosure of fair value under US generally-accepted accounting principles ("US GAAP"). Proposal Release at 8-14.
- 4 Proposal Release at 17-18.
- 5 Proposal Release at 19-22.
- 6 Proposal Release at 23-24.
- 7 Proposal Release at 24-26. In evaluating and overseeing pricing services, the SEC noted that a fund board or adviser generally should take into consideration factors such as (i) the qualifications, experience, and history of the pricing service; (ii) 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; (iii) the pricing service's process for considering price "challenges," including how the pricing service incorporates information received from pricing challenges into its pricing information; (iv) the pricing service's potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and (v) the testing processes used by the pricing service.
- 8 Proposal Release at 26-28.
- 9 Proposal Release at 28-30.
- 10 The Proposal Release stated that a fund's board could make this assignment to a fund's primary adviser or one or more sub-advisers. For example, 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 and that a multi-manager fund could have multiple advisers assigned the role of determining fair value of the different investments that those advisers manage. Proposal Release at 33.
- 11 Proposal Release at 31-34.
- 12 Proposal Release at 34-35.
- 13 At a minimum, proposed rule 2a-5 would require that such periodic report provided by the adviser include a summary or description of the following:

- (A) the assessment and management of material valuation risks described in Section A above (including any material conflicts of interest of the investment adviser (and any other service provider));
- (B) any material changes to, or material deviations from, the fund's fair value methodologies;
- (C) the results of the testing of the fund's fair value methodologies;
- (D) the adequacy of resources allocated to the process for determining the fair value of assigned investments (including any material changes to the roles or functions of the persons responsible for determining fair value);
- (E) any material changes to the adviser's process for selecting and overseeing pricing services, as well as material events related to the adviser's oversight of pricing services (such as changes in the service providers used or price overrides); and
- (F) any other materials requested by the board related to the adviser's process for determining the fair value of assigned investments.

Proposal Release at 42-45.

14 Proposal Release at 54-55.

15 Proposal Release at 34-56. With respect to funds that are set up as unit investment trusts, the proposed rule would require the trustee to determine the fair value in good faith.

16 The SEC based the proposed "readily available" definition from the definition of level 1 inputs in ASC Topic 820, which the SEC views as substantially similar to the corresponding "readily available market quotation" definition in ASR 113. Proposal Release at 58, note 129 and accompanying text.

17 Proposal Release at 57-60.

18 Proposal Release at 66-68.

19 Proposal Release at 88-89.

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