The SEC is responding to the evolution of markets and fund investment practices since 1970, when it last issued comprehensive valuation guidance.

What you need to know

- The SEC proposed a new rule under the Investment Company Act of 1940 (the 1940 Act) that would create a framework for the valuation practices of registered investment companies and business development companies.

- The proposal would establish requirements that fund boards must follow to determine in good faith the fair value of portfolio holdings without readily available market quotations for purposes of the 1940 Act and would codify the common practice of assigning the determination of fair value to a fund’s adviser, subject to certain conditions.

- The proposal would require fund boards or advisers they assign to determine fair value to periodically assess and manage material valuation risks, including material conflicts of interest.

- The SEC also proposed rescinding certain guidance on the recognition, measurement, disclosure and auditing of fund investments.

- Comments are due by 21 July 2020.

Overview

The Securities and Exchange Commission (SEC) proposed a new rule under the 1940 Act that would modernize fund valuation practices and clarify how fund boards and trustees of unit investment trusts can satisfy their obligation to determine fair value in good faith for portfolio holdings without readily available market quotations.
The proposed rule would codify the common practice of assigning the determination of fair value to a fund’s adviser but would require boards to take specific steps to oversee the adviser’s determination of fair value. The proposed rule would establish a framework to help boards consistently oversee this process. The rule also would, for the first time, define what the 1940 Act means when it refers to “readily available market quotations.”

In issuing the proposal, the SEC is responding to the evolution of markets and fund investment practices since 1970, when it last issued comprehensive valuation guidance. Today, registered investment companies and business development companies (collectively, funds) invest in a greater variety of securities and other instruments that require more good faith fair value determinations than when the current SEC guidance was written.

Key considerations

Determining fair value in good faith

The proposed rule would permit a fund’s board to assign the determination of fair value to the fund’s investment adviser, subject to certain conditions and oversight requirements. To determine fair value in good faith for securities for which market quotations are not readily available, fund boards or advisers would be required to (1) periodically assess and manage material valuation risks, including material conflicts of interest, (2) establish and apply fair value methodologies, (3) test those methodologies, (4) oversee and evaluate pricing services used by the fund and (5) adopt and implement written policies and procedures addressing the determination of fair value.

While the proposed rule would not identify the valuation risks that boards or advisers must address, other than material conflicts of interest, the SEC provided a non-exhaustive list of the types and sources of valuation risk. They include the types of investments held by the fund, potential market or sector shocks or dislocations, the extent to which unobservable inputs are provided by the adviser, and both the proportion of investments measured at fair value and their contribution to the fund’s return. They also include the reliance on third-party pricing services, the extent to which these pricing services rely on their own service providers and the risk that the fair value methods used are inappropriate and applied inconsistently or incorrectly.

The SEC noted that the valuation risks for each fund would depend on its investments. Although the SEC did not specify how frequently a board or adviser would reassess the fund’s valuation risks, it indicated that the periodic assessment should consider changes in fund investments, significant changes in a fund’s investment strategy or policies, market events and other factors.

Under the proposal, a fund’s board or adviser would have to (1) select and consistently apply appropriate methodologies for determining and calculating the fair value of investments (including specifying key inputs and assumptions for each asset class or portfolio holding and the methodologies for new types of fund investments that a fund intends to acquire), (2) periodically review the appropriateness and accuracy of the methodologies selected and make any necessary adjustments (e.g., based on the results of back-testing or calibration), (3) monitor for circumstances that may necessitate the use of fair value (e.g., significant events that occur in foreign markets after those markets close but before the fund prices its shares and that materially affect the value of a portfolio holding traded on a foreign exchange) and (4) establish criteria for determining when market quotations are no longer reliable.
The SEC noted a methodology used to determine fair value would need to be consistent with Accounting Standards Codification (ASC) 820, *Fair Value Measurement*. The SEC also noted that while methodologies would have to be applied consistently, they could be adjusted to result in a measurement that is equally or more representative of fair value.

The SEC said a range of appropriate values could reasonably be considered to be the fair value for an investment, and whether a specific value in the range represents fair value depends on the facts and circumstances of the particular investment.

A fund’s board or adviser would have to test the appropriateness and accuracy of the fair value methodologies selected. The SEC said the results of calibration and back-testing could be useful in identifying trends and any issues with methodologies used by fund service providers. The SEC also indicated that the board or adviser should look into whether observed transactions indicate that a selected methodology consistently overvalues or undervalues a fund’s investment.

When using pricing services, a board or adviser would be required to establish the process for the approval, monitoring and evaluation of any pricing service provider, which the SEC said should take into consideration factors such as (1) the pricing service’s qualifications, experience and history, (2) the valuation methods or techniques, inputs and assumptions used by the pricing service for different classes of holdings, and how they are affected by changing market conditions, (3) the pricing service’s process for considering price challenges, (4) the pricing service’s potential conflicts of interest and the steps taken to mitigate such conflicts and (5) the testing processes used by the pricing service. A board or adviser also would be required to establish criteria for initiating price challenges, which the SEC said could include setting objective thresholds.

A fund or adviser also would have to adopt and implement written policies and procedures on fair value determination that are reasonably designed to comply with the items discussed above. The fund would be required to maintain appropriate documentation to support fair value determinations for at least five years, including information on the methodologies used, the assumptions and inputs considered, and any necessary or appropriate adjustments in methodologies. The SEC noted this documentation needs to be sufficient for a third party to verify the fair value determination.

When a board assigns the fair value determination to the fund’s adviser, the adviser would be required to provide to the board, at least quarterly, a written assessment of the adequacy and effectiveness of the adviser’s process for determining fair value. This report would summarize or describe, at a minimum, (1) the assessment and management of material valuation risks, (2) any material changes to, or deviations from, the established fair value methodologies, (3) the results of the testing of the fair value methodologies, (4) the adequacy of resources allocated to the fair value determination process, (5) any material changes to the adviser’s process for selecting and overseeing pricing services and any material events related to the adviser’s oversight of such pricing services and (6) any other information requested by the board.

The SEC indicated other information that boards could request may include (1) summaries of price challenges and price overrides, (2) calibration and back-testing data, (3) stale pricing reports, (4) reports of investments whose prices changed outside predetermined ranges, (5) reports on pricing errors, (6) the adviser’s due diligence reports about pricing services, (7) results of independent auditor testing included in audit committee communications, (8) reports on trends in investments fair valued in good faith and (9) reports on securities valued using information received from broker-dealers.
Additionally, the adviser would have to report to the board within three business days on matters related to its process that materially affect or could have materially affected the fair value of portfolio 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.

The adviser also would specify the titles and functions of the people responsible for determining the fair value of investments and reasonably segregate the process of making fair value determinations from the portfolio management of the fund. The proposed requirement related to segregation is intended to reduce and manage conflicts of interest but would not prevent portfolio managers from providing inputs to fair value determinations. In addition, the adviser should establish a process for the review of price overrides.

The fund would have to maintain for five years copies of (1) the reports and other information presented to the board and (2) a list of investments or investment types whose fair value determination has been assigned to the adviser.

**How we see it**

The SEC said boards should approach the oversight of a fund adviser’s fair value determinations with skepticism and objectivity. The SEC also said it expects a board’s level of scrutiny to increase when inputs and assumptions are more subjective.

**Readily available market quotations**

The 1940 Act requires a fund’s board to determine the fair value of portfolio holdings for which market quotations are not “readily available.” The proposed rule states that a market quotation would be readily available only when it is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date.

That means a quote would be unreliable and, therefore, not readily available if US GAAP would require an adjustment or the consideration of additional inputs to value the security. The SEC said “indications of interest” or “accommodation quotes” would not be readily available market quotations and reaffirmed its previous statement that evaluated prices are not by themselves readily available market quotations.

**Rescission of existing guidance**

The SEC also proposed rescinding the guidance on the recognition, measurement, disclosure and auditing of investment securities, which is included in Accounting Series Release (ASR) Nos. 113 and 118 that were issued in 1969 and 1970, respectively. The SEC believes this guidance is no longer necessary because ASC 820 modernized the approach to the accounting topics addressed in these ASRs and the Public Company Accounting Oversight Board was created by the Sarbanes-Oxley Act of 2002 to establish guidance for auditors.