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Proposed SEC Rule 2a-5 under the Investment Company Act of 1940

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Introduction

It has been 50 years (1969-70) since the Securities and Exchange Commission last addressed valuation practices under the Investment Company Act of 1940 ("the Act") in a comprehensive manner. Back then, New York had multiple winning sports teams; people wore bellbottoms; we visited the moon.

Rule 2(a)(41) of the Act requires funds to establish the value of their illiquid portfolio investments at "fair value" as determined in good faith by the fund's board. The SEC's proposed **Rule 2a-5** encompasses 140 pages of valuation rules, definitions, background, procedures and requirements. This article seeks to condense that to four pages (you're welcome).

In the past two decades, three developments have fundamentally altered how boards, advisors, independent auditors, valuation agents, and other market participants address valuation for various purposes under the federal securities laws. The first such development was the enactment of the Sarbanes-Oxley Act of 2002 and establishment of the Public Company Accounting Oversight Board ("PCAOB").

Second, was the adoption in 2003 of rules under the Act designed to enhance compliance with federal securities laws by requiring funds and advisors to implement written compliance policies and procedures that are designed to prevent violation of those laws, including: monitoring for circumstances that may necessitate the use of fair value; establishing criteria for determining when market quotations are no longer reliable for a particular portfolio security; providing a methodology or methodologies by which the fund determines fair value; and regularly reviewing the appropriateness and accuracy of the methodology(ies) used to determine fair value, and making necessary adjustments.

Third, was the issuance and codification by the Financial Accounting Standards Board ("FASB") of ASC 820 in 2006-2009. ASC 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. generally-accepted accounting principles ("US GAAP").

The SEC believes these regulatory developments have significantly altered the framework in which funds, boards, fund investment advisors, valuation agents, and auditors perform various functions relating to fair value determinations. Accordingly, under proposed **Rule 2a-5**, fair value as determined in good faith would require the following:

i. assessing and managing material risks associated with fair value determinations;
ii. selecting, applying, and testing fair value methodologies;
iii. overseeing and evaluating any pricing services and valuation agents used;
iv. adopting and implementing policies and procedures; and
v. maintaining appropriate records.

Valuation Risk

There are many sources of valuation risk. The SEC highlighted several concerns:

- new transaction structures, opaque investments, and complex capital structures;
- potential market or sector shocks/dislocations;
- the extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the advisor;
- the proportion of the fund's investments that are fair valued 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 (over time and investment type).

Rule 2a-5 provides that fair value as determined in good faith requires selecting and applying, in a consistent manner, appropriate methodologies for determining the fair value of fund investments. This includes specifying: (1) the key inputs and assumptions for 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 proposed rule also would require the selected methodologies to be periodically reviewed for appropriateness and accuracy, and to be adjusted if necessary.

ASC Topic 820 refers to three principal valuation approaches: the income approach, the market approach, and the cost approach. To be appropriate under the 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 these approaches. **Rule 2a-5** would require the establishment of criteria for determining when market quotations are no longer reliable or readily available. **Rule 2a-5** would also require testing the appropriateness and accuracy of the methodologies used to calculate fair value. Consistent with the new AICPA Valuation Guide, the SEC specifically noted that calibration and back-testing can be particularly useful in identifying trends, and also have the potential to assist in identifying issues with methodologies applied by third party providers.

Third Party Valuation

In introducing the proposed rule, SEC Chairman Jay Clayton noted, "The way a fund values its investments… affects the fees they pay, the returns they receive, and the value of the fund shares they hold. [This] proposal would improve valuation practices, including oversight, thereby protecting investors and improving market efficiency, integrity and fairness." One of the principal positive developments highlighted by the SEC is the use by many funds of third-party valuation/pricing agents to provide independent valuations or price confirmations, particularly for illiquid, thinly traded, and/or complex investments.

For funds that use pricing services or valuation agents, **Rule 2a-5** would require that the board or advisor establish a process for the approval, monitoring, and evaluation of each pricing service. The SEC recommends that the board or advisor take into consideration factors such as (i) the qualifications, experience, and history of the pricing service or valuation agent; (ii) the valuation methods or techniques, inputs, and assumptions used by the pricing service or valuation agent for different classes of holdings, and how they are affected as market conditions change; (iii) the pricing service or valuation agent's process for considering price "challenges;" (iv) the pricing service or agent's potential conflicts of interest and the steps the service/agent takes to mitigate such conflicts; and (v) the testing processes used by the pricing service or agent.

Rule 2a-5 would require written policies and procedures addressing the determination of fair value of a fund's investments. **Rule 2a-5** would also require maintenance of the following:

- Supporting Documentation - 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, the first two years in an easily accessible place; and
- Policies and Procedures - A copy of valuation policies and procedures that are in effect, or that were in effect at any time within the past five years, in an easily accessible place.

Although the SEC has previously taken the position that a fund's board may not delegate the determination of fair value to another, the SEC recognizes that compliance with the Act does not require a board to actually perform each of the specific tasks required to calculate fair value. Prior guidance from the SEC recognized that determinations of fair value often require significant resources and specialized expertise, and that it is often impracticable for directors themselves to perform every one of the necessary tasks without assistance. Few boards today are directly involved in the performance of the day-to-day valuation tasks required to determine fair value. Instead the board enlists the fund's investment advisor to oversee or perform these functions (directly or through a third-party pricing/valuation agent), subject to the former's supervision and oversight.

Where the board assigns fair value determinations to an advisor, **Rule 2a-5** would require the board to satisfy its statutory obligation with respect to such determinations through appropriate and adequate oversight. Boards should approach their oversight of fair value determinations assigned to a fund investment advisor with a skeptical and objective view that takes into account the fund's particular valuation risks (including potential conflicts); the appropriateness of the fair value determination process; and the skill and resources devoted to it. The SEC also affirmed that effective oversight cannot be a passive activity. Directors should ask questions and seek relevant information. **Rule 2a-5** would require the advisor to report to the board with respect to matters related to the advisor's fair value process, in part to ensure that the board has sufficient information to conduct this oversight. As the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures (i.e., for illiquid and/or Level Three investments), the board's level of scrutiny should increase correspondingly.

Boards should probe the appropriateness of the advisor's fair value processes. In particular, boards should periodically review the financial resources, technology, staff, and expertise of the advisor, and the experience and qualifications of other service providers relating to valuation. In addition, boards should consider the advisor's compliance capabilities that support the fund's fair value processes, and the oversight and financial resources made available to the chief compliance officer relating to fair value.

Focus of the New Rule: Stale Values, Independence, and Segregation of Duties

Rule 2a-5 specifically cautions regarding:

- Reports of portfolio holdings for which there has been no change in price or for which investments have been held at cost for an extended period of time ("stale prices");
- Reports regarding portfolio holdings whose price has changed outside of predetermined ranges over a set period of time; and,
- Price overrides that are to be reported as supplemental information to the board as part of periodic reporting.

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In addition, **Rule 2a-5** would require the advisor to reasonably segregate the process of making fair value determinations from the portfolio management of the fund. The SEC noted that a significant source of conflict of interest in the fair value determination process is the level and kinds of inputs that fund portfolio managers have in the design or modification of fair value methodologies, or in the calculation of specific fair values. On one hand, the fund's portfolio manager is often the most knowledgeable person at an investment advisor regarding a fund's portfolio holdings. For this reason, it is appropriate for portfolio managers to provide input into the process for determining the fair value of fund investments. On the other hand, because portfolio managers are often compensated in part based upon the returns of the fund, a portfolio manager's incentives may not be fully aligned with the board's interest in objective determinations of fair value; therefore a portfolio manager should not bear primary responsibility for making fair value determinations.

Rule 2a-5 would require reasonable segregation of fair value functions and is intended to mitigate the possibility that the aforementioned competing incentives diminish the effectiveness of proper fair value determinations. The SEC naturally expects that funds that hold more securities that are measured using Level Two or Level Three inputs would be more affected by this proposed rule than long/short public securities funds.

Proposed **Rule 2a-5**: Key Changes and Policy Implications

Rule 2a-5 differs from the current regulatory framework and funds' current practices in several ways.

Under the current regulatory framework, funds have flexibility to determine their fair value policies and procedures, reporting, and recordkeeping requirements. **Rule 2a-5** would differ from the current 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 their advisors. In particular, the rule would prescribe more specific elements that fair value policies and procedures must address as compared to the current framework (see Rule 38a-1).

Rule 2a-5 would impose uniform minimum requirements on all affected funds related to their fair value policies and procedures, reporting, and recordkeeping. The SEC believes boards of funds that hold more illiquid and hard-to-value securities are more likely to assign these fair value determinations to an advisor, and oversee the process of determining fair value, because investment advisors (and third-party pricing/valuation firms) are often better suited to value such investments.

In proposing the rule, the SEC feels funds and their investors would benefit because it would allow boards to allocate more fair value responsibilities to investment advisors, freeing board resources tied to valuation to be redirected to oversight, strategy, evaluation of management, Environmental, Social & Governance (ESG) initiatives, and other value-added board functions. Uniform guidance, external assistance, greater administrative certainty, and fewer comment letters could lower costs of compliance, which ultimately would benefit fund investors as cost savings can be passed down in the form of lower fund operating expenses.

Where funds' fair value policies and procedures are less thorough than the policies and procedures of **Rule 2a-5**, and board oversight of investment advisors' conflicts of interest is less effective than under the proposed rule, **Rule 2a-5** is intended to decrease the likelihood that fund investments would be inaccurately fair valued. **Rule2a-5** should create a more robust valuation framework and offer more accurate and unbiased asset prices, especially for investors in funds that are not publicly traded (e.g., open-end funds, Business Development Companies [BDC's], other private alternative asset managers) because there is no secondary market for the shares of those funds and such investors can only trade at NAV, which is set by the fund's fair value determinations.

The comment period for proposed **Rule 2a-5** will remain open until July 21, 2020.
Should you have any questions please feel free to contact us.

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