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SEC Proposal May Foretell Valuation Enforcement Focus

By **George Talarico** (May 13, 2020, 6:27 PM EDT)

For the first time since Apollo 13 safely splashed down, the U.S. Securities and Exchange Commission seeks to comprehensively update valuation practice under the Investment Company Act of 1940.[1]

On April 21, the commission proposed a new Rule 2a-5 under the Investment Company Act.[2] Proposed Rule 2a-5 details the requirements for the determination of registered investment companies' and business development companies' fair value in good faith[3] and focuses on: (1) valuation procedures; and (2) the role of the funds' board of directors in the determination of the fair value of the funds' investments.



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Existing Valuation Framework

Before the proposed Rule 2a-5 the SEC dealt with valuation issues in an ad hoc fashion, issuing Account Series Releases 113 and 118 in 1969 and 1970, respectively. The SEC also issued guidance on valuation issues through a 1999 letter to the Investment Company Institute.[4] ASR 113 addressed valuation issues concerning restricted securities.[5]

The SEC stated that restricted securities purchased at discounted prices should not be valued as if they were unrestricted securities.[6] Further ASR 113 escalated the board's obligations in regards to valuation by noting that it is the board's responsibility to determine the fair value of restricted securities:[7]

While the board may, consistent with this responsibility, determine the method of valuing each issue of restricted security in the company's portfolio, it must continuously review the appropriateness of any method so determined.[8]

The board's obligation in making fair value determinations continued to evolve and expand in ASR 118. In ASR 118, the SEC reemphasized the board's "continuous review" obligation contained in ASR 113[9] and added that, to meet the requirements of the Investment Company Act Section 2(a)(41), it is incumbent upon the board "to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered." [10]

This marked the beginning of the SEC's requirement that the board of directors' obligations exceeds good faith.

In its 1999 letter to the ICI, the SEC defended the guidance issued in ASR 113 and 118 by stating that "we believe that they continue to represent the views of the Commission." [11]

The SEC did, however, expand on ASR 113 and 118 by adding more factors for the board to consider primarily to address the "development of world financial markets and the proliferation of new financial products." [12]

Proposed Rule 2a-5

While the SEC has recently expressed its concern on valuation issues, proposed Rule 2a-5 makes it clear that valuation is a priority. SEC Chairman Jay Clayton, commenting on proposed Rule 2a-5, has stated that the

way a fund values its investments is critical to our Main Street investors. ... It affects the fees they pay, the returns they receive, and the value of the fund shares they hold. Today's proposal would improve valuation practices, including oversight, thereby protecting investors and improving market efficiency, integrity and fairness.[13]

Proposed Rule 2a-5, which explicitly rescinds prior SEC valuation guidance (e.g. ASR 113 and 118), [14] would

apply to all registered investment companies and BDCs, regardless of their classification or sub-classification (e.g., open-end funds and closed-end funds, including BDCs), or their investment objectives or strategies (e.g., equity or fixed income; actively managed or tracking an index).[15]

Proposed Rule 2a-5 while rescinding ASR 113 and 118 also expands on the obligations contained in these ASRs and establishes the requirements for good faith determinations of the fair value of a fund's investments for securities and assets without readily available market quotations.[16]

Proposed Rule 2a-5 continues the evolution of ever-increasing board obligations.[17] It also describes the steps the board must take to satisfy these obligations including:

- Valuation risks: Assess and manage material risks associated with fair value determinations.
- Fair value methodologies: Select, apply and test fair value methodologies.
- Pricing services: While proposed Rule 2a-5 explicitly permits the fund to use third-party pricing services, the board must oversee and evaluate pricing services, if applicable.
- Fair value policies and procedures: The board must adopt and implement written policies and procedures which are "reasonably designed to achieve compliance" with proposed Rule 2a-5.
- Record-keeping: The fund must maintain certain records including supporting documentation and policies and procedures.[18]

Notably, and contrary to its previous prohibition, proposed Rule 2a-5, permits the board to assign valuation questions to the fund's investment adviser.[19] This assignment would not relieve the board of its obligations, as boards

should approach their oversight of fair value determinations assigned to an investment adviser of the fund with a skeptical and objective view that takes account of the fund's particular valuation risks, including for conflicts, appropriateness of the fair value determination process, and the skill and resources devoted to it.[20]

Simply allowing the adviser to hire a third-party valuation firm or pricing service will not relieve the board of its oversight role or need to fully understand how valuation is being conducted. Such an assignment should only be done with:

- Oversight: The board must actively and robustly oversee the adviser.
- Reporting. The board must receive specific reporting by the adviser periodically and promptly.
- Specification of functions: Clear delineation of responsibilities and reasonable segregation of duties among the adviser's personnel.

- Records of assignment: In addition to the other required records, the fund must keep records relating to the adviser's fair value determinations such as reports provided to the board and a listing of which investments have been assigned to the adviser for valuation.[21]

Thus, in instances where boards assign valuation to the fund's investment adviser and notwithstanding the explicit statutory language of the Investment Company Act Section 2(a)(41)(A) — "fair value as determined in good faith by the board of directors" — boards will no longer be determining fair value, but rather held to the express and detailed assignment oversight responsibilities imposed by proposed Rule 2a-5.

Readily Available

Before the proposed Rule 2a-5, the SEC has not provided guidance on the definition of when market quotations are considered readily available. To align its standard with the ASC 820 and U.S. generally accepted accounting principles, proposed Rule 2a-5 provides that a market quotation is considered 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." [22]

Implications

Proposed Rule 2a-5 marks a continuation of the SEC's increased compliance demands on funds' fair value determinations. We should, therefore, expect that enforcement actions concerning improper fund valuation practices will be more intense than past such actions.

The majority of past enforcement actions for improper fair value determinations involve a failure by the fund to adopt or follow written valuation procedures.[23] For example, in the Fifth Street order, the SEC stated that Fifth Street "failed to adopt and implement written policies and procedures" in its valuation process.[24] Also, in the J. Kenneth Alderman order, the SEC aimed at the board finding that:

[T]he Directors did not calculate the valuations themselves, and neither established clear and specific valuation methodologies nor followed up their general guidance to review and approve the actual methodologies used and the resulting valuations. Instead, they approved policies generally describing the factors to be considered but failed to determine what was actually being done to implement those policies.[25]

Other enforcement actions concerning funds' valuation practices focused on: failures to account for market changes;[26] and, misallocation of rent and other expenses.[27] Fund valuation policies are a perennial favorite for SEC enforcement and are a clearly stated priority for the SEC.[28]

Coupled with the increased emphasis on board supervision and oversight as well as detailed requirements for fund boards to satisfy their good faith obligation in determining fair value, we can expect increased enforcement action opportunities in this area.

Conclusion

It is impressive that the SEC is capable of dropping a 141-page proposal during these difficult times. It is also a clear indication that the commission is taking valuation issues seriously.

While the final form of the rule has not been finalized — comment period is open until July 21 — we anticipate that it will not significantly deviate from proposed Rule 2a-5. As such, funds should be prepared to review and update the sections of their compliance manuals that address valuation and implement the review, monitoring, methodologies, record keeping, testing, and other requirements of the new rule.

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[1] SEC Proposes to Modernize Framework for Fund Valuation Practices, SEC Press Release dated April 21, 2020 (the "Press Release"). <https://www.sec.gov/news/press-release/2020-93>.

[2] Good Faith Determinations of Fair Value, Release No. IC-33845; File No. S7-07-20 (the "proposed Rule 2a-5"). <https://www.sec.gov/rules/proposed/2020/ic-33845.pdf>.

[3] The Act, § 2(a)(41).

[4] See, e.g., Division of Investment Management: December 1999 Letter to the ICI Regarding Valuation Issues, December 8, 1999 (the "ICI Letter"). <https://www.sec.gov/divisions/investment/guidance/tyl120899.htm>.

[5] Statement Regarding "Restricted Securities," Accounting Series Release No. 113 (Oct. 21, 1969). <https://www.sec.gov/rules/interp/1969/ic-5847.pdf>.

[6] *Id.* at p. 2-3.

[7] *Id.* at p.5.

[8] *Id.*

[9] Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118 (Dec. 23, 1970).

[10] *Id.* at p. 19988.

[11] The ICI Letter at p. 1.

[12] *Id.*

[13] Press Release.

[14] *Id.*

[15] Proposed Rule 2a-5 at p. 16.

[16] *Id.* at p.57.

[17] For an overview of the evolving role of funds' board of directors, see, e.g. Chair Mary Jo White, The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference, Mar. 29, 2016. <https://www.sec.gov/news/speech/chair-white-mutual-fund-directors-forum-3-29-16.html>.

[18] *Id.* at p. 17 et seq.

[19] *Id.* at p. 15.

[20] *Id.* at p. 34-35.

[21] *Id.* at p 31 et seq.

[22] *Id.* at p. 57-58.

[23] See, e.g., *In re Deer Park Road Management Company, LP. et al.* Investment Advisers Act Release No. 5245 (June 4, 2019) (settlement) (SEC imposed a \$5 million fine where fixed asset manager's written policies for valuing client assets and implementation of these policies was deficient); *In re Oppenheimer Asset Management Inc., et al.*, Investment Advisers Act Release No.

3566 (Mar. 11, 2013) (settlement) (fund improperly utilized a valuation procedure that was different than the one contained in its pitch books that were provided to investors); **In re Fifth Street Management, LLC.** , Investment Advisers Act Release No. 5070 (Dec. 3, 2018) (settlement) (BDC overvalued its investments due to its repeated failures to upload the most recent financial information); **In re J. Kenneth Alderman et al.** , Investment Company Act Release No. 30557 (June 13, 2013) (settlement) (cease and desist order issued against directors for failure to oversee valuation procedures).

[24] Fifth Street Order at p.5.

[25] J Kenneth Alderman Order at p. 11.

[26] **In re KCAP Financial, Inc., et al.** , Securities Exchange Act Release No. 68307 (Nov. 28, 2012) (settlement).

[27] See, e.g., Fifth Street Order at p. 3.

[28] Press Release.

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