

SEC Proposes New Fair Value Rule 2a-5

TYPE OF PROVISION	EXISTING REGULATORY FRAMEWORK	PROPOSED RULE
<p><b>Performance of Fair Value Determinations</b></p>	<p>The SEC has taken the position that Section 2(a)(41) prohibits a fund’s board from delegating its statutory duty to determine the fair value of fund portfolio securities. Fund boards appoint others, such as the fund’s investment adviser or a valuation committee, to assist the board in determining fair value.<sup>21</sup></p>	<p>A fund board may assign fair value determinations relating to any or all fund investments to an investment adviser of the fund, including authority to revise methodologies, subject to board oversight and certain reporting requirements.</p>
<p><b>Adoption of Policies and Procedures</b></p>	<p>Rule 38a-1 under the 1940 Act requires a fund to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund.</p> <p>The adopting release for Rule 38a-1 provides that such policies and procedures must require a fund to: (1) monitor for circumstances that may necessitate the use of fair value prices; (2) establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; (3) provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and (4) regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments.</p>	<p>Rule 38a-1 continues to apply. In addition, the Proposed Rule would require the party making fair value determinations to adopt and implement written policies and procedures addressing the determination of the fair value of fund investments that are reasonably designed to comply with requirements that the party: (1) periodically assess any material risks associated with the determination of the fair value of fund investments, including material conflicts of interest, and manage those identified valuation risks; (2) establish and apply fair value methodologies<sup>22</sup>; (3) 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; and (4) oversee pricing service providers, if used, including establishing (i)</p>

<sup>21</sup> See, e.g., Money Market Fund Reform, *supra* note 2, at n.896.

<sup>22</sup> Under the Proposed Rule, establishing and applying fair value methodologies requires the performance of the following functions, taking into account the fund’s valuation risks: (1) selecting and applying in a consistent manner an appropriate methodology or methodologies for determining (and calculating) the fair value of fund investments, including specifying (i) the key inputs and assumptions specific to each asset class or portfolio holding, and (ii) which methodologies apply to new types of fund investments in which a fund intends to invest; (2) periodically reviewing the appropriateness and accuracy of the methodologies selected and making any necessary adjustments thereto; (3) monitoring for circumstances that may necessitate the use of fair value; and (4) establishing criteria for determining when market quotations are no longer reliable.

SEC Proposes New Fair Value Rule 2a-5

TYPE OF PROVISION	EXISTING REGULATORY FRAMEWORK	PROPOSED RULE
		the process for the approval, monitoring, and evaluation of each pricing service provider, and (ii) criteria for initiating price challenges.
<b>Board Oversight and Reporting</b>	There are no express board oversight and reporting requirements under the current regulatory framework. The SEC staff have stated that a board must “periodically review the appropriateness of the methods used to fair value price portfolio securities and the quality of the prices obtained through these procedures, and . . . make changes when appropriate.” <sup>23</sup>	<p>The Proposed Rule would impose specific reporting requirements. If a board assigns fair value determinations to an investment adviser, the investment adviser must provide the board with a written report no less frequently than quarterly that assesses the adequacy and effectiveness of the investment adviser’s process for determining the fair value of the assigned portfolio of investments.<sup>24</sup></p> <p>Additionally, the adviser must report promptly (but in no event later than three business days after the adviser becomes aware of the matter) on matters that materially affect or could have materially affected the fair value of the assigned portfolio of 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.</p>

<sup>23</sup> Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (December 8, 1999).

<sup>24</sup> This report must include, at a minimum, a summary description of: (1) the assessment and management of material valuation risks required by the Proposed Rule, including any material conflicts of interest of the investment adviser (and any other service provider); (2) any material changes to, or material deviations from, the fair value methodologies established pursuant to the Proposed Rule; (3) the results of the testing of fair value methodologies required by the Proposed Rule; and (4) 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 pursuant to the Proposed Rule; (5) 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 (6) any other materials requested by the board related to the adviser’s process for determining the fair value of assigned investments.

SEC Proposes New Fair Value Rule 2a-5

TYPE OF PROVISION	EXISTING REGULATORY FRAMEWORK	PROPOSED RULE
<b>Specification of Responsibilities</b>	<p>There are no requirements for funds or advisers to specify responsibilities regarding fair value determinations. Many Rule 38a-1 compliance policies and procedures establish a valuation committee to implement fair value methodologies in a manner that is designed to mitigate any potential conflicts of interest.</p>	<p>If a board assigns fair value determinations to an investment adviser, the investment adviser must specify the titles of the persons responsible for determining the fair value of the assigned investments and the functions for which they are responsible.</p> <p>Advisers also must reasonably segregate the process of making fair value determinations from the portfolio management of the fund. If an adviser assigns responsibility to a valuation committee or similar body to assist in the process of determining fair value, the fair value policies and procedures generally should describe the composition and role of the committee, or reference any related committee governance documents as appropriate.</p>
<b>Recordkeeping</b>	<p>There are no recordkeeping rules that specifically address fair value determinations.</p> <p>Rule 38a-1(d) requires the maintenance of certain records, including copies of: all compliance policies and procedures; materials provided to the board in connection with their approval of fund and service provider policies and procedures under the rule; the CCO's annual report to the board; and any records documenting the board's annual review of fund and service provider compliance policies and procedures under the rule.</p> <p>Rule 204-2 under the Investment Advisers Act of 1940 requires an adviser to maintain copies of the adviser's compliance policies and</p>	<p>The Proposed Rule would impose specific recordkeeping requirements with respect to fair value determinations.</p> <p>In addition to existing recordkeeping requirements, a fund must maintain: (1) appropriate documentation to support fair value determinations, including information regarding the specific methodologies applied and the assumptions and inputs considered, as well as any necessary or appropriate adjustments in methodologies, and (2) a copy of policies and procedures.</p> <p>When a board assigns fair value determinations to an investment adviser, the fund must maintain copies of: (1) the reports and other</p>

SEC Proposes New Fair Value Rule 2a-5

TYPE OF PROVISION	EXISTING REGULATORY FRAMEWORK	PROPOSED RULE
	<p>procedures and any records documenting its annual review of such policies and procedures.<sup>25</sup></p> <p>Other provisions of the federal securities laws require that registered investment companies maintain appropriate books and records in support of the fund's financial statements and preserve for a specified period (generally six years) all schedules evidencing and supporting each computation of net asset value.<sup>26</sup> In addition, funds reporting under the Securities Exchange Act of 1934 must make and keep books, records, and accounts that accurately and fairly reflect their transactions and dispositions of their assets in reasonable detail.<sup>27</sup></p>	<p>information provided to the board; and (2) a list of the investments or investment types whose fair value determination has been assigned to the adviser.</p>
<p><b>Definition of “readily available” market quotations</b></p>	<p>Neither the 1940 Act nor the rules thereunder currently define “readily available.”</p> <p>In the Proposing Release, the SEC states that it understands that “industry practice has developed to incorporate many of the concepts of ASC Topic 820 when evaluating whether market quotations are readily available.”</p>	<p>The Proposed Rule would define “readily available” to align with concepts in U.S. GAAP.</p> <p>A market quotation would qualify as 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.</p>

<sup>25</sup> See 17 CFR 275.204-2. See also Compliance Programs of Investment Companies and Investment Advisers, SEC Release Nos. IA-2204, IC-26299 (Dec. 17, 2003) at section II.D.

<sup>26</sup> See 1940 Act Section 31(a) and Rules 31a-1 and 31a-2, 17 CFR 270.31a-1 and .31a-2.

<sup>27</sup> 15 U.S.C. 78m(b)(2)(A).