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SEC Proposes Fair Valuation Rule for Registered Funds and BDCs with New Requirements for “Good Faith” Determinations

By Barry Barbash, Benjamin Haskin, and Margery Neale

The Securities and Exchange Commission (SEC) recently proposed new Rule 2a-5 (Proposed Rule) under the Investment Company Act of 1940 (1940 Act) to provide a framework for the fair valuation of portfolio investments of registered open-end and closed-end investment companies (registered funds) and business development companies (BDCs), and with registered funds (funds).¹ Under Section 2(a)(41) of the 1940 Act, securities in a fund's portfolio for which market quotations are “readily available”² must be valued at their market value, and all other securities and assets must be valued at their “fair value as determined in good faith by the [fund's] board of directors.” Section 2(a)(41) contains one of only a few specific references in the 1940 Act to a duty imposed on a fund's board of directors,³ yet prior to the current rule proposal, the most recent SEC guidance with respect to fair valuation by funds was in a pair of statements issued in 1969 and 1970.⁴ The fund industry has long sought updated guidance from the SEC with respect to fair valuation generally, and, more specifically, with respect to the delegation of a board's duties for fair valuation to the fund's investment adviser and sub-adviser (together, adviser).

Fair Valuation...*continued from page 1*

The Proposed Rule would require the performance of certain enumerated activities to determine in good faith the fair value of fund investments for purposes of Section 2(a)(41), and provides that a fund's board can "assign" the determination of fair value to the fund's investment adviser, so long as the board or adviser takes certain actions, including implementing certain board oversight procedures and reporting. The Proposed Rule would also define when market quotations are "readily available" for purposes of Section 2(a)(41).⁵ If the Proposed Rule is adopted, the SEC and the Staff, as applicable, would rescind or withdraw previously issued guidance addressing fund valuation matters covered by the Proposed Rule.

Given the critical importance of the valuation process to the operation of registered funds and BDCs and the prescriptive nature of the Proposed Rule, industry comment is anticipated on a number of topics related to the proposal.

Summary of Proposed Rule

The Proposed Rule has three principal elements:

1. Specifying how a fund board can "assign" fair valuation determinations to the fund's investment adviser, including the implementation of quarterly board oversight procedures, quarterly board reporting, and prompt board notification in certain circumstances;
2. Providing a comprehensive framework for making fair value determinations in "good faith," including requirements with respect to the assessment and management of valuation risks, the establishment and application of fair value methodologies, the testing of fair value methodologies, the evaluation of pricing services, the adoption of fair valuation policies and procedures, and recordkeeping; and
3. Including a definition of when a market quotation is "readily available," which would be "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."⁶

Background

The 1940 Act requires registered funds and BDCs to value their portfolio securities using market value when market quotations for those securities are "readily available." In all other cases, funds must value their investments at fair value, as determined in good faith by the fund's board.⁷ A fund's net asset value (NAV) reflects the aggregate value of a fund's investments (minus liabilities), and funds generally use their NAV per share to determine the price at which their shares are offered, redeemed or repurchased. The valuation of a fund's investments will affect, among other things, the accuracy of advisory fee⁸ and other asset-based fee or expense calculations; disclosures of fund performance,⁹ aggregate NAV and NAV per share; compliance with investment policies and limitations; and the protection of shareholder interests from dilution.¹⁰ The Proposing Release does not state that the Proposed Rule is designed to address systemic or comprehensive industry problems with valuation. Nevertheless, from time to time, the SEC has brought and settled a number of enforcement cases alleging that securities held by registered funds and BDCs were not appropriately valued.¹¹ In some of these cases, the SEC alleged that board members did not comply with their statutory duties.¹²

The SEC last comprehensively addressed valuation under the 1940 Act in Accounting Series Releases in 1969 and 1970 (ASR Releases).¹³ Importantly, in the ASR Releases, the SEC acknowledged that a fund's board "need not itself perform each of the specific tasks required to calculate fair value in order to satisfy its obligations under Section

2(a)(41).” The ASR Releases required a fund’s board to: (1) choose the valuation methods; (2) continuously review the appropriateness of such methods;¹⁴ (3) consider all factors relevant to calculating fair value for securities that did not have readily available market quotations;¹⁵ and (4) carefully review any valuation conclusions drawn by individuals who were not directors and arrive at a fair valuation conclusion for themselves.¹⁶

The Proposing Release identifies three significant regulatory developments that occurred subsequent to the ASR Releases, which have shaped how funds, fund boards, and other market participants have approached valuation under the federal securities laws.¹⁷ These developments are:

1. The enactment of the Sarbanes-Oxley Act of 2002, the adoption of rules under that Act, and the establishment of the Public Company Accounting Oversight Board.
2. The adoption in 2003 of compliance rules under the 1940 Act and the Investment Advisers Act of 1940 (Advisers Act), specifically Rule 38a-1 under the 1940 Act and Rule 206(4)-7 under the Advisers Act.¹⁸
3. The Financial Accounting Standards Board’s establishment of a framework for the recognition, measurement, and disclosure of fair value under US generally accepted accounting principles (US GAAP) in 2009 (that is, Financial Accounting Standards Board ASC Topic 820 (ASC Topic 820)).

The Proposing Release notes, in addition to these three regulatory developments, that securities markets and fund investment practices have changed considerably over the last 50 years.¹⁹ The Proposing Release also recognizes the extensive current use by funds of third-party pricing services to obtain pricing information, and advances in technology that have greatly increased the availability of current pricing information. Fund investments have become more varied over the past decades, and

pose greater valuation challenges that, the Proposing Release acknowledges, often require greater resources and expertise than when the SEC issued the ASR Releases.

The SEC proposes to rescind prior valuation guidance set out in the ASR Releases in its entirety.²⁰ The Proposing Release also contains a preliminary list of SEC Staff letters and guidance that address fund valuation matters and that would be withdrawn if the Proposed Rule is adopted. The SEC Staff letters that would be withdrawn include two letters issued to the Investment Company Institute, which have been frequently looked to by the industry since they were issued on December 8, 1999²¹ and April 30, 2001.²²

Effectiveness and Comments

The Proposed Rule, if adopted, would be effective one year after publication of the final rule in the Federal Register, upon which the ASR Releases and any additional identified guidance would be withdrawn.

The Proposing Release includes numerous questions soliciting comments. Comments were due on or before July 21, 2020.

Assignment of Fair Value Determinations

The Proposing Release acknowledges that few fund boards today are directly involved in the day-to-day valuation tasks required to determine fair value, and that many of these tasks are often performed by the fund’s adviser pursuant to long-standing SEC and Staff guidance.²³ The Proposed Rule would provide that a fund’s board may choose to determine fair value in good faith for any or all fund investments by carrying out all required functions, including, among other things, monitoring for circumstances that necessitate fair value determinations and selecting and applying valuation methodologies.²⁴ Under the Proposed Rule, a fund’s board can “assign” fair value determinations to an adviser, subject to board oversight and additional reporting, recordkeeping,

and other requirements intended to facilitate the board's oversight of the adviser's fair value determinations, as discussed below.²⁵

Board Oversight Generally

The Proposed Rule would prescribe extensive and specific board oversight obligations (as detailed below) if fair value determinations are assigned to the fund's adviser. The Proposing Release also broadly describes the very active oversight expected of fund boards, stating that in the SEC's view "effective oversight cannot be a passive activity" and that boards should be "skeptical and objective" in assessing advisers' valuation determinations.²⁶ Boards, according to the SEC, would be expected to oversee the adviser with an appropriate level of scrutiny relative to the fund's valuation risk, and to question the appropriateness of the adviser's fair value processes, including through oversight over conflicts of interest.²⁷ The Proposing Release states that boards should "seek to identify potential issues and opportunities to improve the fund's fair value processes."²⁸

Oversight Through Board Reporting

Under the Proposed Rule, much of the board's oversight responsibilities would be intertwined with specific board reporting requirements, as described below. The adviser's reports would be required to include information reasonably necessary to give the board sufficient information and to ensure that the board can exercise the level of oversight contemplated by the Proposed Rule.

Periodic Reporting

The Proposed Rule would require the adviser to provide the board with at least quarterly written assessments of the adviser's fair value determination processes.²⁹ The adviser's periodic reports would provide the board with the adviser's evaluation of the adequacy and effectiveness of the adviser's process for determining fair value. At a minimum, the report would be required to include a summary or description of the following:

- Assessment and management of material valuation risks, including any material conflicts of interest of the adviser (and any other service providers);
- Any material changes to, or material deviations from, the established fair value methodologies;
- The results of the testing of fair value methodologies;
- 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;
- 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
- Any other materials requested by the board related to the adviser's process for determining the fair value of assigned investments.³⁰

Prompt Board Reporting in Writing of Material Matters

The Proposed Rule would require the adviser to report to the board promptly in writing matters associated with the adviser's process that materially affected, or could have materially affected, the fair value of the assigned portfolio of the fund's investments, including a significant deficiency or material weakness in design or implementation of the adviser's fair value determination process or material changes in the fund's valuation risks.³¹ The Proposed Rule would require that the adviser provide these reports promptly, but in no event later than three business days after the adviser becomes aware of the matter.

Specification of Functions at the Adviser

If the board were to assign fair value determinations to an adviser (as opposed to implementing fair valuation determinations directly), the adviser

would be required under the Proposed Rule to specify the titles and particular functions of each person responsible for determining the fair value of the investments.³² Specific personnel with duties associated with price challenges would need to be identified in the fair value policies and procedures. In seeking to prevent conflicts of interests from influencing a determination of fair value, the Proposed Rule would also require the adviser to reasonably segregate the process of making fair value determinations from the portfolio management of the fund. The Proposing Release acknowledges that portfolio management personnel can provide important perspectives with respect to the value of a fund holding. The Proposing Release notes, however, that these perspectives should be balanced against any potential conflicts of interest to which a portfolio manager may be subject in assisting with the determinations. This segregation of functions requirements does not necessarily contemplate a communications “fire-wall” or strict protocols on personnel communication. Rather, to achieve reasonable segregation of functions, an adviser may structure a fund’s portfolio management functions and fair value determination processes in ways specific to the fund’s surrounding circumstances.

Records Related to Assigned Fair Valuation Determinations

The Proposed Rule would require a fund to keep records related to fair valuation determinations assigned to the adviser, including: (1) copies of reports and other information provided by the adviser to the fund’s board as required by the Proposed Rule; and (2) a specified list of investments or investment types whose fair value determinations have been assigned to the adviser pursuant to the Proposed Rule’s requirements.³³ The records would be required to be kept 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, the first two years in an easily accessible place.

Framework for Determining Fair Value in Good Faith (Irrespective of Whether Fair Value Is Assigned to the Adviser)

Section 2(a)(41)(B) of the 1940 Act generally defines “value” to mean “(i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors.” The Proposed Rule contains several requirements for determining fair value in good faith:

Valuation Risks

Under the Proposed Rule, determining fair value in good faith would require periodic assessment and management of material risks associated with fair value determinations.³⁴ The only specific valuation risk that would be required to be addressed under the Proposed Rule is the existence of material conflicts of interest, as any other specific valuation risks would depend on the facts and circumstances of a particular fund’s investments. Valuation risks may include the risks associated with the initial determination of whether an investment must be fair valued, as well as valuation risks that may arise from the following potential sources identified in the Proposing Release:³⁵

- Types of investments held or intended to be held by the fund;
- Potential market or sector shocks or dislocations (potential indicators of which could include a significant change in trading volume, significant change in short-term volatility or market liquidity, or a sudden increase in trading suspensions);
- Extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the adviser;
- Proportion of the fund’s investments that is fair valued as determined in good faith, 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;
- Changes in fund investments, significant changes in a fund's investment strategy or policies, market events and other relevant factors; and
- Risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.

The frequency for the required assessment of a fund's valuation risks is not specified in the Proposed Rule. Determination of the frequency of such valuation risk assessment should take into account changes in fund investments, significant changes in a fund's investment strategy or policies, market events, and other relevant factors.

Fair Value Methodologies

The Proposed Rule would provide that determining fair value in good faith requires selecting and applying in a consistent manner an appropriate methodology or methodologies for determining (and calculating) the fair value of fund investments. This requirement would include detailing:

- Key inputs and assumptions specific to each asset class or portfolio holding; and
- Methodologies the fund would apply to new types of investments intended to be held by the fund.³⁶

As discussed further below in "Definition of Readily Available Market Quotations," any methodology used for purposes of determining fair value must be consistent with US GAAP, including the criteria established in ASC Topic 820.³⁷ The Proposing Release acknowledges that no single methodology for determining fair value would be applicable to

all investments due to the particular facts and circumstances of each investment that shape its fair value, including the relevant market and market participants.³⁸

The Proposed Rule would require that fair value methodologies be considered for fund investments that a fund does not currently hold, but in which it intends to invest in the future.³⁹

The Proposed Rule would also require that a fund's board or, if the fair value determination is assigned to the fund's adviser under the Proposed Rule, the adviser, monitor for circumstances or significant events that, if occurring, would make market quotations unreliable and thus, for purposes of the Proposed Rule, not readily available,⁴⁰ and the Proposed Rule would then require the board or adviser to use fair value as determined in good faith.⁴¹

Testing Fair Value Methodologies

The Proposed Rule would require that funds test fair value methodologies, including testing the appropriateness and accuracy of the fair value methodologies selected.⁴² The Proposed Rule would also require the identification of the testing methods to be used, and the minimum frequency of the testing.⁴³ The Proposing Release cites calibration and back-testing as particularly useful methods for identifying trends, poor performance of fair value methodologies applied by fund service providers, or potential conflicts of interest.⁴⁴

Pricing Services

Funds today rely on pricing services to a much greater extent than when the SEC issued the ASR Releases. The Proposed Rule would require oversight and evaluation of any pricing services used by a fund. The board or adviser, as applicable, would be required to establish a process for approving, monitoring, and evaluating each pricing service provider. The Proposing Release states that such process should take into account:⁴⁵

- The qualifications, experience, and history of the pricing service;
- 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. In this regard, the fair value policies and procedures should address whether the pricing service is relying on inputs or assumptions provided by the adviser;
- The pricing service's process for considering price challenges, including how the pricing service incorporates information received from price challenges into its pricing information;
- The pricing service's potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and
- The testing processes used by the pricing service.

When pricing information from a pricing service differs materially from the determination of the fair value of an investment, the board or adviser (if the role has been assigned by the board) may contact the pricing service to question the basis for the pricing information. The Proposed Rule would require a fund to establish criteria for circumstances under which price challenges would typically be initiated.⁴⁶ Summaries of price challenges brought by the adviser is one example noted in the Proposing Release of relevant information that the board could review and consider in the adviser's periodic reports to the board.⁴⁷

Fair Value Policies and Procedures

The Proposed Rule would require adoption and implementation of written policies and procedures addressing fair value determination of a fund's investments. The fair value policies and procedures would be required to be reasonably designed to achieve compliance with the requirements of the Proposed Rule. Under the Proposed Rule, when the fund's board determines the fair value of investments, the board-approved fair value

policies and procedures would need to be adopted and implemented by the fund. When fair value determinations are assigned to the adviser, the adviser-approved fair value policies and procedures would need to be adopted and implemented by the adviser, subject to board oversight pursuant to Rule 38a-1 under the 1940 Act.

Rule 38a-1 currently requires, among other things, a fund's board to approve the fund's compliance policies and procedures and those of each adviser and other specified service providers, based on a finding that the policies and procedures are reasonably designed to prevent violation of the federal securities laws. When adopting Rule 38a-1, the SEC indicated its expectation that fund compliance policies encompass the pricing of portfolio securities and fund shares, and funds appear uniformly to have implemented those policies.⁴⁸ The Proposing Release states that Rule 38a-1 would "encompass a fund's compliance obligations with respect to [the Proposed Rule], if adopted, and would require a fund's board to oversee compliance with [the Proposed Rule]."⁴⁹ To the extent that adviser policies and procedures under the Proposed Rule would otherwise be duplicative of fund valuation policies under Rule 38a-1, a fund could adopt the policies and procedures of the adviser under the Proposed Rule in fulfilling its Rule 38a-1 obligations. If the Proposed Rule is adopted, it would supersede the SEC's discussion in connection with the adoption of Rule 38a-1, which noted specific policies and procedures that were to be considered with respect to the pricing of portfolio securities and fund shares.

Recordkeeping

The Proposed Rule would require the fund to maintain certain records. These records would include appropriate documentation supporting fair value determinations, which must be kept for at least five years from the time the determination was made, the first two years in an easily accessible place. The Proposed Rule would also require a copy of policies and procedures that are in effect or that were

in effect at any time within the past five years to be retained in an easily accessible place.

Definition of Readily Available Market Quotations

Under section 2(a)(41) of the 1940 Act, fund investments must be fair valued as determined in good faith by the board when market quotations are not “readily available.”⁵⁰ Neither the 1940 Act nor the rules thereunder currently define “readily available” for purposes of section 2(a)(41). The Proposed Rule would define the term as follows:

a market quotation is 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.

The Proposing Release acknowledges that current industry practice incorporates many of the concepts of ASC Topic 820 when evaluating whether market quotations are readily available.⁵¹

As discussed above, the Proposing Release generally refers to US GAAP for appropriate valuation standards.⁵² In setting out the proposed definition for when market quotations are “readily available,” the Proposing Release specifically refers to ASC Topic 820’s definition of level 1 assets.⁵³ The Proposed Rule would treat a market quotation 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, which reflects a change from the current “facts and circumstances” framework.⁵⁴

The Proposed Rule would also provide that a quotation is not readily available if it is not reliable.⁵⁵ A quotation would be considered to be unreliable if it would require adjustment under US GAAP or would require additional consideration or inputs in order to determine the value of the security, such as

may be needed for a security that principally trades on a closed foreign market when an event occurs prior to the fund calculating its NAV that would likely result in a change in its price.⁵⁶

In addition to the incorporation of US GAAP guidance, the Proposing Release explicitly states that “evaluated prices” would not be readily available market quotations for purposes of the Proposed Rule.⁵⁷

Looking Forward

The Proposed Rule would impose specific, detailed board oversight and related management reporting responsibilities to satisfy a board’s “good faith” standard in assigning valuation responsibilities to an adviser. That aspect of the Proposed Rule drew a critique from SEC Commissioner Hester M. Peirce, who issued a public statement commenting on the “overly prescriptive” nature of the Proposed Rule as to the specific exercise of a board’s duties to oversee the adviser’s fair valuation of securities. In particular, she asked:

Why is this level of prescription necessary? Boards are perfectly able to ensure that they have a full picture of their advisers’ valuation activities without the Commission imposing a series of one-size-fits-all requirements in a new regulation.⁵⁸

She went on to say that fund boards have a great deal of experience in overseeing fair valuation under the existing framework of Rule 38a-1 and that “[p]roposed rule 2a-5 should reflect that reality rather than trying to overlay unnecessary duplicative requirements on top of it.”⁵⁹

While “good faith” is not defined in the 1940 Act or the other federal securities laws, traditional interpretations of the “good faith” standard have often looked to “a state of mind consisting of ...honesty in belief or purpose,”⁶⁰ particularly in the context of the duties of directors, rather than meeting highly specific procedural requirements. Consistent with

this interpretation of the good faith standard under Section 2(a)(41), the SEC Staff stated in a 2001 no-action letter to the Investment Company Institute (ICI Letter), that, with respect to Rule 2a-4:

[...] a board acts in good faith when its fair value determination is the result of a sincere and honest assessment of the amount that the fund might reasonably expect to receive for a security upon its current sale, based upon all of the appropriate factors that are available to the fund. Furthermore, we believe that a board acts in good faith when it continuously reviews the appropriateness of the method used in determining the fair value of the fund's portfolio securities. *Compliance with the good faith standard generally reflects the directors' faithfulness to the duties of care and loyalty that they owe to the fund.*⁶¹

As a practical matter, many of the requirements embedded in the fair valuation framework of the Proposed Rule are consistent with industry practices that have developed over the years. That said, given the historic association of "good faith" with a general state of mind rather than prescribed actions, it would be consistent with the requirement of Section 2(a)(41) as to a board's good faith determination of fair value for the SEC to consider Commissioner Peirce's critique of the Proposed Rule. Specifically, as the SEC moves to adoption of a final rule 2a-5, consideration should be given to making the board elements of the rule less prescriptive, to allow boards to assign fair valuation responsibilities subject to oversight programs that are tailored to the funds that they oversee. It is anticipated that some industry comments will focus on this aspect of the Proposed Rule.

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& Gallagher LLP. The authors would like to thank Christine Sun, Curtis Tate and Matthew Hedrick for their assistance with this article. The views of the authors are not necessarily the views of Willkie Farr & Gallagher LLP.

NOTES

- ¹ *Good Faith Determinations of Fair Value*, 1940 Act Release No. 33845 (Apr. 21, 2020), available at <https://www.sec.gov/rules/proposed/2020/ic-33845.pdf> (Proposing Release). The Proposed Rule would apply to all registered funds and BDCs, regardless of their classification or sub-classification or their investment objectives or strategies. The Proposed Rule would also include a specific provision relating to fair valuation determinations by a unit investment trust as defined in the 1940 Act (UIT). Because a UIT does not have a board of directors or an investment adviser, a UIT's trustee would be required to conduct fair value determinations in accordance with the provisions of the Proposed Rule.
- ² "Readily available" is not defined in the 1940 Act.
- ³ See also Sections 15 and 32 of the 1940 Act.
- ⁴ See *Statement Regarding "Restricted Securities,"* Accounting Series Release No. 113 (Oct. 21, 1969) (ASR 113); *Accounting for Investment Securities by Registered Investment Companies*, Accounting Series Release No. 118 (Dec. 23, 1970) (ASR 118).
- ⁵ Proposing Release at 22.
- ⁶ *Id.* at 57-58.
- ⁷ Section 2(a)(41) of the 1940 Act. See also 1940 Act Rule 2a-4. "Good faith" is not defined in the 1940 Act or the rules thereunder.
- ⁸ See, e.g., Section 205 of the Investment Advisers Act of 1940 (permitting a fund's adviser to receive compensation based upon the total value of the fund and permitting certain specified types of performance fee arrangements with funds).
- ⁹ See, e.g., Item 4(b)(2) of Form N-1A (requiring certain disclosures about fund performance in fund prospectuses); Item 4.1 and Instruction 4.b. to Item 24 of Form N-2 (requiring disclosure of the fund's NAV in its prospectus and annual report); Item 6 of Form

N-CSR and § 210.12-12 of Regulation S-X (requiring a schedule of the fund's investments, including the value of the investment, in the fund's annual report).

¹⁰ See *Investment Company Liquidity Risk Management Programs*, 1940 Act Release No. 32,315 (Oct. 13, 2016) (adopting rule 22e-4 under the 1940 Act and noting "the risk of shareholder dilution associated with improper fund pricing"). On one hand, if fund shares are overpriced, selling shareholders will receive too much for their shares, and purchasing shareholders will pay too much for their shares. On the other hand, if fund shares are underpriced, selling shareholders will receive too little for their shares, and purchasing shareholders will pay too little for their shares. See generally *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 136-38 (1940) (discussing the effect of dilution on fund shareholders).

¹¹ See, e.g., *Mitchell Hutchins Asset Management Inc.*, Securities Act Release No. 7444, Securities Exchange Act Release No. 39001, Investment Company Act Release No. 22805, 1997 WL 537042 (Sept. 2, 1997); *Parnassus Investments*, Securities Exchange Act Release No. 40534, 1998 WL 698382 (ALJ Oct. 8, 1998); *Carroll A. Wallace*, Securities Exchange Act Release No. 48372, 2003 WL 21982215 (Aug. 20, 2003); *vacated by Wallace*, Securities Exchange Act Release No. 50480, 2004 WL 2203263 (Sept. 30, 2004); *The Rockies Fund, Inc.*, Securities Exchange Act Release No. 48590, Investment Company Act Release No. 26202, 2003 WL 22273596 (Oct. 2, 2003); *aff'd in part, rev'd in part and vacated as to sanction*, 428 F.3d 1088 (D.C. Cir. 2005); *Allied Capital Corp.*, Securities Exchange Act Release No. 55931, 2007 WL 1773811 (June 20, 2007); and *Evergreen Investment Management Company, LLC*, Securities Exchange Act Release No. 60059, Investment Company Act Release No. 28759, 2009 WL 1585837 (June 8, 2009); see also *infra* n.13.

¹² See *Heartland Advisors, Inc.*, Securities Act Release No. 8884, Securities Exchange Act Release No. 57206,

Investment Company Act Release No. 28136, 2008 WL 220057 (Jan. 25, 2008); *J. Kenneth Alderman*, Investment Company Act Release No. 30557 2013 WL 2646182 (June 13, 2013).

¹³ ASR Releases, *supra* n.4.

¹⁴ ASR 118 at 19988 ("[I]t is incumbent upon the Board of Directors . . . to determine the method of arriving at the fair value of each such security."). See also *Money Market Fund Reform; Amendments to Form PF*, Investment Company Act Release No. 31166 (July 23, 2014) (2014 Money Market Fund Release) at n.896 (*citing* ASR 118). In ASR 113, the SEC similarly stated: "It is the responsibility of the board of directors to determine the fair value of each issue of restricted securities in good faith While the board may, consistent with this responsibility, determine the method of valuing each issue of restricted securities in the company's portfolio, it must continuously review the appropriateness of any method so determined."

¹⁵ ASR 118 at 19988 ("[I]t is incumbent upon the Board of Directors to satisfy themselves that all appropriate factors relevant to the fair value of securities for which market quotations are not readily available have been considered."). See also 2014 Money Market Fund Release, *supra* n.14 at n.896 (*citing* ASR 118).

¹⁶ ASR 118.

¹⁷ Proposing Release at 10.

¹⁸ Under Rule 38a-1, a fund must adopt compliance policies and procedures with respect to fair valuation, including to monitor for circumstances that may necessitate the use of fair value; to establish criteria for when market quotations are no longer reliable; to provide methodologies by which the fund determines fair value; and to review regularly the appropriateness and accuracy of such methodologies and make any necessary adjustments. Proposing Release at 12.

¹⁹ Proposing Release at 13-14.

²⁰ Proposing Release at 64.

²¹ Inv. Company Inst., SEC Interpretive Letter, 1999 WL 35020116 (Dec. 8, 1999).

²² Inv. Company Inst., SEC No-Action Letter, 2001 WL 436249 (Apr. 30, 2001). Other items that would

be withdrawn include Form N-7 for Registration of Unit Investment Trusts under the Securities Act of 1933 and the 1940 Act, Investment Company Act Release No. 15612, Appendix B, Guide 2 (Mar. 17, 1987) and Valuation Guidance Frequently Asked Questions (FAQ 1 only) (2014).

²³ See Proposing Release at 9.

²⁴ See Proposed Rule 2a-5(b).

²⁵ See *id.*

²⁶ *Id.* at 35.

²⁷ The Proposing Release states: “We also believe that, consistent with their obligations under the Act and as fiduciaries, boards should seek to identify potential conflicts of interest, monitor such conflicts, and take reasonable steps to manage such conflicts. In so doing, the board should serve as a meaningful check on the conflicts of interest of the adviser and other service providers involved in the determination of fair values.” Proposing Release at 36.

²⁸ Proposing Release at 35.

²⁹ Proposed Rule 2a-5(b)(1).

³⁰ The Proposing Release states that boards may want to consider, among other things, the following:

- Summaries of adviser price challenges to pricing information provided by third-party vendors and of price overrides, including back-testing results related to the use of price challenges and overrides;
- Specific calibration and back-testing data, including in the case of back-testing whether fair value prices moved in the same direction (relative to the prior market prices) as the portfolio holdings’ next actual market prices, whether fair value prices were closer to the portfolio holdings’ next actual market prices than the prior market prices (regardless of the direction), and whether the difference between the fair value prices and the subsequent prices was greater than pre-established tolerance levels;
- Reports regarding 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;
- Narrative summaries or reports on pricing errors, including the date of any error, the cause, the impact on the fund’s NAV, and any remedial actions taken in response to the error;
- Reports on the adviser’s due diligence of pricing services used by the fund;
- The results of testing by the fund’s independent auditor provided to the audit committee;
- Reports analyzing trends in the number of the fund’s portfolio holdings that received a fair value, as well as the percent of the fund’s assets that received a fair value; and
- Reports on the number and materiality of securities whose fair values were determined based on information provided by broker-dealers; the broker-dealers most frequently used for this purpose; and the results of back-testing on the information they provided.

Proposing Release at 46-47.

³¹ Proposed Rule 2a-5(b)(1)(ii).

³² Proposed Rule 2a-5(b)(2).

³³ Proposed Rule 2a-5(b)(3).

³⁴ Proposed Rule 2a-5(a)(1).

³⁵ Proposing Release at 17-18.

³⁶ Proposed Rule 2a-5(a)(2). Regarding the key inputs and assumptions specific to each asset class or portfolio holding, it would not be sufficient, for example, to simply state that private equity investments are valued using a discounted cash flow model, or that options are valued using a Black-Scholes model, without providing any additional detail on the specific qualitative and quantitative factors to be considered, or the sources of the methodology’s inputs and assumptions, and a description of how the calculation is to be performed (which may, but need not necessarily, take the form of a formula). See Proposing Release at 19-20, n. 45.

³⁷ ASC Topic 820’s alternative approaches to fair valuation are: market approach (using prices and other information generated from market transactions

in similar assets and liabilities), income approach (using a discounting methodology to convert future amounts to a current amount), and cost approach (based on the amount required to replace an asset's service capacity), as well as other valuation techniques and methods by which to measure fair value. Proposing Release at 20.

³⁸ *Id.*

³⁹ Proposed Rule 2a-5(a)(2)(A). *See also* Proposing Release at 21 (“For example, the board or adviser, as applicable, generally should address, prior to the fund’s investing in a new type of investment, whether readily available market quotations will be used or if the investment may need to be fair valued on occasion or at all times. For certain types of investments, it should be clear that the asset will require a fair value at all times. For others, however, market quotations may sometimes be readily available and sometimes not, so that periodically a fair value will need to be determined. The board or adviser generally should seek to identify sources of price inputs before the fund invests in such asset classes, if possible, in addition to determining an appropriate fair value methodology, and generally should document these decisions.”).

⁴⁰ *See infra* n.56.

⁴¹ Proposed Rule 2a-5(a)(2)(C).

⁴² Proposed Rule 2a-5(a)(3).

⁴³ *See* Proposing Release at 23-24.

⁴⁴ *Id.* at 24.

⁴⁵ *See id.* at 25.

⁴⁶ Proposed Rule 2a-5(a)(4).

⁴⁷ *See* Proposing Release at 45.

⁴⁸ Proposing Release at 59. *See also Compliance Programs of Investment Companies and Investment Advisers*, Investment Company Act Release No. 26299 (Feb. 4, 2004). *See also supra* n.18.

⁴⁹ Proposing Release at 27.

⁵⁰ Section 2(a)(41)(B)(ii) of the 1940 Act. *See also* 1940 Act rule 2a-4.

⁵¹ ASC Topic 820 (defining “fair value” for purposes of accounting standards and establishing a framework for the recognition, measurement, and disclosure of fair value under US GAAP). Proposing Release at 58.

⁵² *See, e.g.*, Proposing Release at 59. *See also* “Fair Value Methodologies” *supra* ns. 36–41.

⁵³ The Proposing Release acknowledges that the proposed definition taken from ASC Topic 820 is different from the one in ASR 113, which refers to “securities similar in all respects,” rather than “identical assets,” but asserts that “we view these respective definitions as being substantively the same.” *See* Proposing Release, at 58, note 129.

⁵⁴ *See* “An Introduction to Fair Value Pricing,” Investment Company Institute (Spring 2005) at 11.
⁵⁵ Proposing Release at 58.

⁵⁶ *See* Proposing Release at 59.

⁵⁷ “In addition, indications of interest and accommodation quotes, for example, would not be ‘readily available market quotations’ for the purposes of the Proposed Rule.” Proposing Release at 73, citing to 2014 Money Market Fund Release, *supra* n.14.

⁵⁸ Hester M. Peirce, Commissioner, SEC, Statement on Good Faith Determinations of Fair Value under the Investment Company Act of 1940 Proposal (Apr. 21, 2020).

⁵⁹ *Id.*

⁶⁰ *Good Faith*, Black’s Law Dictionary (11th ed. 2019).

⁶¹ *Inv. Company Inst.*, *supra* n.22 (emphasis added) (internal quotations removed). The US District Court for the District of Delaware, interpreting state law, similarly referred to good faith as a director’s earnest effort to fulfill his or her duties and promote the interest of the corporation as opposed to bad faith actions, which are characterized by no such effort. *See, e.g.*, *Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006); *Caremark Intern. Inc. Derivative Litig.*, 698 A.2d 959 (Del 1996). In *Walt Disney Co.*, the Delaware Supreme Court stated that “failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.”