



# SEC proposes modernized fund valuation framework

**Proposal would simplify regulatory requirements, while maintaining fair value integrity**

The Securities and Exchange Commission (SEC) has proposed modifying the valuation practices and the role of the board of directors in determining the fair value of investments held by a registered investment company or a business development company (hereafter, “fund”).

The proposed rule,<sup>1</sup> announced April 21, 2020, would provide requirements for determining fair value in good faith by the board of directors and management. These requirements would involve:

- 1 Assessing and managing material risks associated with fair value determinations
- 2 Selecting, applying, and testing fair value methodologies
- 3 Overseeing and evaluating any pricing services used
- 4 Adopting and implementing policies and procedures
- 5 Maintaining certain records.

The proposed rule would permit a fund’s board of directors to assign the fair value determination to an investment adviser, who would carry out these functions for some or all of the fund’s investments. The proposed rule also defines when market quotations are considered readily available.

If the proposed rule is adopted, the SEC would rescind previous guidance on the role of the board of directors in determining fair value and the accounting and auditing guidance related to fund investments, including Accounting Series Releases (ASRs) 113 and 118.

A one-year transition period has been proposed so funds and their advisers can prepare to comply with the proposed rule.



## KPMG insights

The SEC’s experience through the financial crisis and the current COVID-19 environment have informed their views of the board’s oversight of fair valuation and whether the accounting and auditing standards issued by the FASB and PCAOB have protected investors through these events.

**—John Russo**  
Partner

<sup>1</sup> Release No. IC-33845, *Good Faith Determinations of Fair Value*



## What's required to determine fair value?

The proposed rule includes a number of required functions to be performed to determine in good faith the fair value of the fund's investments. These requirements would apply either to a fund's board or to an adviser assigned by the board, whichever one is determining the fair value. These requirements include:

**1. Valuation risks.** A board or adviser would periodically assess any material risks associated with determining the fair value of the fund's investments, including material conflicts of interest, and managing those identified valuation risks. The proposed rule details a list of potential sources of valuation risk, such as the types of investments held or intended to be held by the fund, the extent to which each fair value methodology uses unobservable inputs, and the use of third-party service providers and their level of expertise.

It's important to note that other than material conflicts of interest, the proposed rule doesn't identify the specific valuation risks to be addressed under this requirement but allows the board of directors or the adviser to address the specific risks based on the fund's investments. KPMG believes this flexibility will be helpful to boards as they can tailor the valuation risks appropriately based on the type of investments held by the fund.

**2. Fair value methodologies and testing of the methodologies.** The proposed rule requires selecting and applying, in a consistent manner,<sup>2</sup> appropriate methodologies for determining and calculating the fair value of fund investments.<sup>3</sup> This requirement would include specifying (1) the key inputs and assumptions specific to 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. The SEC leaves the specific tests to be performed and their frequency up to the board or adviser; however, the SEC states that it believes the results of calibration and back-testing can be

particularly useful in identifying trends. These also have the potential to assist in identifying issues with methodologies applied by fund service providers, according to the SEC. It is our experience that many boards already receive the results of calibration and back-testing.

In addition, the board or adviser would be required to consider the applicability of the selected fair value methodologies to types of fund investments that a fund doesn't currently hold but in which it intends to invest in the future. The SEC notes that the board or adviser generally should address, prior to the fund's investing in a new type of investment, whether readily available market quotations will be used or whether the investment may need to be fair valued on occasion or at all times.

The board or adviser would also be required to monitor for circumstances that may necessitate the use of fair value as determined in good faith. The rule would require establishing criteria for determining when market quotations no longer are reliable and therefore aren't readily available.

**3. Pricing services.** For funds that use pricing services, the proposed rule would require that the board or adviser establish a process for the approval, monitoring, and evaluation of each pricing service provider. In addition, the board or adviser would have to establish criteria for the circumstances under which challenges of a pricing vendor's prices typically would be initiated (e.g., establishing objective thresholds).

**4. Fair value policies and procedures.** The proposed rule would require written fair value policies and procedures addressing the determination of the fair value of the fund's investments to be reasonably designed to achieve compliance with the new rule.<sup>4</sup>

**5. Recordkeeping.** The fund would be required to maintain appropriate documentation to support fair value determinations. This documentation would include 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.

<sup>2</sup> The proposed rule would require that the fair value methodologies be consistently applied to the asset classes for which they are relevant; there can be circumstances where it is appropriate to adjust methodologies if the adjustments would result in a measurement that is equally or more representative of fair value.

<sup>3</sup> To be appropriate under the rule, a methodology used for purposes of determining fair value must be consistent with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurement*.

<sup>4</sup> Under the proposed rule, where the board determines the fair value of investments, the board-approved fair value policies and procedures would be adopted and implemented by the fund. Where the board assigns fair value determinations to the adviser, the fair value policies and procedures would be adopted and implemented by the adviser, subject to board oversight.



## Performance of fair value determinations

Under the proposed rule, a fund’s board of directors would be permitted to assign the fair value determination relating to any or all fund investments to an investment adviser of the fund, which would carry out all of the functions required in the fair value determination portion of the proposed rule. A fund’s board could make this assignment to a fund’s primary adviser or one or more sub-advisers.<sup>5</sup> Any board assignment under the proposed rule would be subject to board oversight and certain reporting, recordkeeping, and other requirements designed to facilitate the board’s ability to effectively oversee the adviser’s fair value determinations.

**1. Board oversight.** When the board assigns fair value determinations to an adviser, the proposed rule would require the board to satisfy its statutory obligation with respect to those determinations by overseeing the adviser. The SEC is very clear that the board should view oversight as an iterative process and seek to identify potential issues and opportunities to improve the fund’s fair value processes. Boards should ensure their oversight isn’t passive, as enforcement actions have been brought against boards when the SEC believed this was the case.

For its part, the adviser would be required to report to the board matters related to its fair value process, in part to ensure that the board has sufficient information to conduct its oversight. Boards should also request follow-up information when appropriate and take reasonable steps to see that matters identified are addressed. A board can reasonably rely on information in summaries and other materials provided by the adviser and other service providers in conducting its oversight. However, the SEC believes it’s incumbent on the board to request and review any information it believes is necessary to be fully informed of the adviser’s process for determining the fair value of fund investments.

**2. Board reporting.** Included in the proposed rule are a number of reporting requirements intended to help ensure that boards receive the amount and type of information that they find most valuable in overseeing the adviser.

**a. Periodic reporting.** The proposed rule would require the adviser, at least quarterly, to provide the board with a written assessment of the adequacy and effectiveness of the adviser’s process for determining the fair value of the assigned portfolio of investments. The periodic reports would be required to include, at a minimum, a summary or description of the following:

- I. **Material Valuation Risks.** The assessment and management of material valuation risks that would be required under the proposed rule. This would include any material conflicts of interest of the investment adviser and any other service provider.
- II. **Material Changes to or Material Deviations from Methodologies.** Any material changes to, or material deviations from, the fair value methodologies established under the proposed rule.
- III. **Testing Results.** The results of any testing of fair value methodologies as part of the required fair value policies and procedures.

<sup>5</sup> For example, for a fund with a sub-adviser responsible for managing a portion of the fund’s portfolio, the board could assign the determination of fair value for the investments in that portion of the fund’s portfolio to that sub-adviser. As a result, a multi-manager fund could have multiple advisers assigned the role of determining fair value of the different investments that those advisers manage.



## KPMG insights

The SEC’s proposal to modernize the fair value framework is welcomed. It balances active board oversight with allowing the board to assign the fair value determination to an investment adviser. The proposal focuses on risk assessment, performance, policies, procedures, and recordkeeping. The focus in these areas are consistent with a well-designed fair valuation process.

—**Matt Giordano**  
Partner



- IV. Resources. The adequacy of resources allocated to the process for determining the fair value of the fund's assigned investments, including any material changes to the roles or functions of the persons responsible for determining the fair value.
- V. Pricing Services. Any material changes to the adviser's process for overseeing pricing services, as well as any material events related to its oversight of such services, such as changes of service providers used or price overrides.
- VI. Other Requested Information. Any other materials requested by the board related to the adviser's process for determining the fair value of fund investments

In addition, to the specific items listed above, the SEC has also given a list of other items a board could review and consider if relevant:

- I. Summaries of adviser 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
- II. Specific calibration and back-testing data
- III. 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)
- IV. Reports regarding portfolio holdings whose price has changed outside of predetermined ranges over a set period of time
- V. 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
- VI. Reports on the adviser's due diligence of pricing services used by the fund
- VII. The results of testing by the fund's independent auditor provided to the audit committee
- VIII. 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
- IX. 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.

KPMG believes many of the proposed reporting requirements would codify existing practice for reporting fair value information to boards.

**b. Prompt board reporting.** The proposed rule would require that the adviser, within three business days, report to the board in writing on matters associated with the adviser's process that materially affect, or could have materially affected,<sup>6</sup> the fair value of the assigned portfolio of investments. These would include a significant deficiency or a material weakness in the design or implementation of the adviser's fair value determination process or material changes in the fund's valuation risks.

**c. Specification of functions.** If the board assigns the fair value determination requirements to an adviser, the proposed rule would require the adviser to specify the titles of the persons responsible for determining the fair value of the assigned investments, including specifying the particular functions for which the persons identified are responsible. If the adviser uses 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 if appropriate. In addition, the fair value policies and procedures also should identify the specific personnel with duties associated with price challenges, including those with the authority to override a price, and the roles and responsibilities of such persons, and establish a process for the review of price overrides. The proposed rule would require the adviser to reasonably segregate the process of making fair value determinations from the portfolio management of the fund, as the SEC appears to view the portfolio manager making the final fair value determination as a potential conflict of interest. The SEC notes that the portfolio manager may be the most knowledgeable person regarding the fund holdings, and it may be appropriate for the portfolio manager to provide input into the process for determining for the fair value. However, they shouldn't be making the final fair value determinations. Therefore, the proposed rule includes a segregation requirement that would allow portfolio managers to bring important perspective and insight regarding the value of fund holdings but would not allow them to make the final fair value determination.

<sup>6</sup> "Could have materially affected" is intended to capture certain circumstances where, for example, a matter was detected which affected one security and which may not be material on its own, but, had the matter not been identified, could have materially affected the larger assigned portfolio of investments or some subset of that portfolio.

**d. Records of assignment.** Under the proposed rule, a fund must also keep records related to the fair value determinations assigned to the adviser. Specifically, the fund would be required to: (1) keep copies of the reports and other information provided to the board required by the rule and (2) a specified list of the investments or investment types whose fair value determinations have been assigned to the adviser pursuant to the requirements of the proposed rule.



#### How KPMG can help

KPMG has a number of professionals with deep knowledge in the investment management and valuation space, including four partners who have served on the SEC staff in the Division of Investment Management and a former chair and current member of the AICPA's Investment Company Expert Panel and the Co-Chair of the AICPA's Private Equity and Venture Capital Valuation Task Force. In addition, KPMG has professionals who specialize in valuation and can help boards of directors and management with back testing and calibration of valuation models. We have significant experience providing industry and regulatory updates to management and boards and look forward to assisting you where necessary.



#### Readily available market quotations

The proposed rule would provide that a market quotation is readily available for purposes of section 2(a)(41) of the Investment Company Act of 1940 (the Act) with respect to an investment 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. Fair value, as defined in the Act, must therefore be used in all other circumstances. The SEC goes on to state that it believes that for a fair value methodology to be appropriate under the proposed rule, it must be determined in accordance with U.S. GAAP. In other words, all securities that aren't considered Level 1 securities under ASC Topic 820 under U.S. GAAP would be considered fair valued for purposes of the proposed rule. Examples of what wouldn't be considered "readily available market quotations" for purposes of the proposed rule include evaluated prices for fixed-income securities and adjusted prices for foreign equity securities.



#### Rescission of prior SEC releases

The SEC would rescind prior guidance in ASR 113 and 118 and certain staff letters and guidance addressing a board's determination of fair value and other matters covered by the proposed rule. With the rescission of ASR 118, auditors would have the ability, under current PCAOB rules, to select a sample of a fund's investments to value instead of valuing 100 percent of the investments, which is currently required under ASR 118. This would be a significant change for the industry.

The proposed rule doesn't impact the statutory requirement in the Investment Company Act that requires the auditor to test the existence assertion for all securities by verifying securities owned with the custodian or by actual examination.



#### KPMG insights

The SEC's guidance in ASR 118 and 113 includes both accounting and auditing guidance. By rescinding this guidance and moving fully to FASB guidance for accounting and PCAOB guidance for auditing, they have simplified the requirements.

— Sean McKee  
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