LEARNING CURVE
NEW VALUATION GUIDANCE: A REMINDER OF DIRECTORS' RESPONSIBILITIES

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Mutual fund directors face new challenges as they struggle to comply with new valuation guidance from the Securities and Exchange Commission. The long-awaited guidance appeared without fanfare—buried in the 869-page release adopting money market fund rule amendments published in July—but it may transform the way directors approach fair value of portfolio securities held by all funds, not just money market funds.

In the release, the SEC reminded fund directors that they have a non-delegable statutory duty to determine the fair value of portfolio securities when market prices are not available. The Commission was clear: While directors may "appoint others" to "assist them in determining fair value," the responsibility to actually determine fair value lays at their feet.

The SEC's guidance zeroed in on three valuation issues:

- The use of amortized cost
- Fair value of thinly traded securities
- Oversight of pricing services

The guidance is particularly relevant when viewed in the context of the SEC's previously stated concerns that the fixed-income markets face severe liquidity challenges in the coming months.

AMORTIZED COST METHOD

The SEC confirmed that all investment companies, including floating-rate money market funds and business development companies (BDCs), may continue to use amortized cost to value debt securities with a remaining maturities of 60 days or less, but with strings attached. Fund directors must determine that the fair value of such debt securities is their amortized cost, unless the particular circumstances warrant otherwise.

This policy may come as a surprise to those funds that routinely fair value these short-term securities at amortized cost. But, as far back as 1977, the SEC recognized that there might be situations when the use of amortized cost does not represent fair value. For example, if an issuer's creditworthiness has been impaired, funds should not fair value the issuer's debt at amortized cost even if it matures in 60 days or less.

Acknowledging that past guidance may be fuzzy, the SEC clarified its position: "We generally believe that a fund may only use the amortized cost method to value a portfolio security with a remaining maturity of 60 days or less when it can reasonably conclude, at each time it makes a valuation determination, that the amortized costs value is approximately the same as the fair value of the security as determined without the use of amortized cost valuation."

In other words, each time it makes a fair valuation determination for a debt security with a maturity of 60 days or less, a fund should consider existing credit, liquidity, or interest rate conditions and issuer-specific circumstances before it defaults to the use of amortized cost.

The SEC seems to be saying that you can only use the amortized cost method to value securities if amortized cost approximately equals market value. If that is the case, then why bother using amortized cost?

Fund directors should confirm that fund fair valuation procedures conform to this requirement, and that any pricing agents retained by the fund comply with those procedures.

THINLY TRADED SECURITIES

What is the standard for determining fair value of a thinly traded security? Footnote 891 to the release adopting the new money market fund rules succinctly summarized the SEC's views on this question: "We generally believe that the current sale standard appropriately reflects the fair value of securities and other assets for which market quotations are not readily available. The price that an unrelated willing buyer would pay for a security or other asset under current market conditions is indicative of the value of the security or asset."

The SEC's emphasis on the current sale standard presents challenges for fund directors who must fair value securities when liquidity suddenly and unexpectedly dries up. For example, a fund holding an asset-backed security backed by high-quality, fully liquid assets may only be able to sell that security at fire sale prices if market turmoil dries up liquidity for that particular security.

The SEC unambiguously put this issue to rest: "[F]unds holding debt securities generally should not fair value these securities at par or amortized cost based on the expectation that the funds will hold those securities until maturity, if the funds could not reasonably expect to receive approximately that value upon the current sale of those securities under current market conditions."

The SEC acknowledged that alternative pricing models, such as matrix pricing, involve estimates and judgments and thus may introduce some "noise" into prices. But at the same

time, the Commission suggested that market-based prices provide more meaningful information, especially in light of a fund's statutory obligation to redeem a shareholder's holdings within seven days.

This guidance implies that the fire sale price should apply, even if the fund expects the market price to bounce back to closer to the security's intrinsic value in a week or two or at maturity.

The SEC's guidance concerning thinly traded securities may be particularly challenging for directors of BDCs, which typically hold many illiquid securities whose fair value cannot be determined by using observable measures, such as market prices or models ("Level 3" securities.) BDC directors should apply the similar due diligence when obtaining prices of illiquid securities from their service providers.

Fund directors should understand how funds use matrix pricing and other alternative pricing methodologies and whether and the extent to which the pricing agent believes that these methods reflect the price that a fund would receive upon its current sale of an illiquid security.

USE OF PRICING SERVICES

The SEC believes that funds, especially money market funds with floating NAVs and stable NAV funds that now must perform daily market-based valuations, will increasingly rely on third-party pricing services.

The SEC reminded fund directors that they cannot delegate their duty to determine the fair value of securities for which market prices are not readily available. They may, however, appoint others, such as a fund's investment adviser or a valuation committee, to "assist" them in determining fair value, and to "make the actual calculations" pursuant to valuation methodologies that the directors have approved. If there is any doubt that the SEC means business in enforcing this statutory responsibility, revisit the enforcement proceeding against the independent directors of the Morgan Keegan funds.

Moreover, the SEC emphasized that fund directors must ensure that they considered "all appropriate factors" in determining the fair value of a security, and must "continuously review the appropriateness of the method used in valuing each issue of security" in a fund's portfolio.

The SEC hammered home a message about the role of pricing services: Fund directors cannot blindly rely on the prices they provide. Rather, the SEC expects fund directors to be actively involved in oversight of pricing services, and it specified the information it expects directors to consider "before deciding to use evaluated prices from a pricing service to assist it in determining the fair values" of portfolio securities.

In the minds of many, this standard measurably raises the bar for fund directors. For example, the SEC said, before deciding to use evaluated prices from a pricing service to "assist" them in determining fair value prices, boards "may want to consider" the following questions:

- What are the inputs, methods, models and ssumptions that each pricing service uses to determine its evaluated prices?
- How will changes in the market affect those inputs, methods, models and assumptions?
- How does management assess the quality of prices provided by a pricing service?
- Does a pricing service determine its evaluated prices as close as possible to the time that the funds calculate their NAV?
- Does the board have a good faith basis for believing that the pricing service's pricing methodologies reflect prices that the fund could reasonably expect to obtain for the securities in a current sale under current market conditions?
- If so, what is it?
- If not, is continued use of the pricing service appropriate?

So what is a board to do? For starters, boards should consider implementing a valuation due diligence program for pricing vendors. This program should include asking pricing vendors to respond to the questions described above, and other questions that the board deems relevant, after consulting with management and its pricing committee. In addition, the board should consider meeting in person with each pricing service as part of its due diligence. As important, the board should document its due diligence process to demonstrate that it has fulfilled its non-delegable responsibilities.

What can we expect to see as we walk down the long and winding fair valuation road?

- Funds can expect that the SEC's Office of Compliance Inspections and Examinations exams will focus on how funds oversee pricing services.
- Directors can expect that OCIE will peek inside the boardroom, starting with review of board and committee minutes, to determine the level of board involvement.
- Directors who fall short of the standards as articulated in the SEC's "stealth" guidance should not be surprised to see referrals to the Enforcement Division for possible action.

To be sure, it may be difficult to provide the level of oversight that the SEC seems to suggest. As a result, it would not be surprising for boards to seek new directors who have specialized knowledge related to valuation of fund securities. Similarly, depending on the level of SEC enforcement activity against fund directors, boards may feel compelled to hire a chief valuation officer, or CVO, who would serve a role analogous to the chief compliance officer, but whose sole focus would be to manage board oversight of fair valuation. Like the CCO, the CVO would report directly to the board.

Will the idea of a CVO take hold? We hope it doesn't come to that because it would hasten the plunge into micromanagement, which is a slippery slope. But, we fear, it may be too late.

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