An Introduction to Fair Valuation

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Acknowledgements

The Independent Directors Council (IDC) recently undertook to update its 2005 white paper, "An Introduction to Fair Valuation." We acknowledge and give special thanks to Stacy Fuller, Esq. and Pamela Grossetti, Esq. of K&L Gates LLP for their time, insights, and contributions to this update.

About IDC

IDC represents independent directors and trustees who serve on the boards of mutual funds, closed-end funds, exchange-traded funds, and other registered investment companies. IDC's activities and advocacy promote excellence in fund governance for the benefit of shareholders. IDC's core mission is to:

- Deliver education and programming to enhance the effectiveness of independent directors in service to fund shareholders;
- Foster community and engagement among independent directors, including through peer-to-peer exchange and learning;
- Advocate for public policies from the independent director perspective in support of fund shareholders; and
- Promote public understanding.

An Introduction to Fair Valuation

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Introduction

Registered investment companies (funds) are in the business of investing in securities and other instruments, and the value they place on those instruments has a direct impact on their shareholders. Many funds value each portfolio investment to calculate net asset value per share (NAV) every business day. The fund's NAV then is used to process purchase, redemption, repurchase, and exchange orders by shareholders.

The Investment Company Act of 1940, as amended sets forth the legal framework for valuation: securities for which market quotations are "readily available" must be valued at market value; all other securities and instruments must be valued at "fair value" as determined in good faith by the fund's board of directors or trustees. Although the legal framework is simple, the valuation process has subjective elements and can be complex.

This paper provides an overview of issues to consider in developing, administering and facilitating a board's oversight of a fund's valuation policies and procedures. Each fund's approach to the valuation of securities will depend on many factors particular to that fund. Ultimately, each fund's board and management, acting in good faith and exercising their reasonable business judgment, will have to consider a broad array of factors to devise an appropriate approach to fund valuation.

Key Developments on Fair Valuation

1940

The Investment Company Act of 1940 is enacted, requiring fund boards to determine fair value prices in good faith when market quotations are not readily available.

1969

The Securities and Exchange Commission (SEC) issues Accounting Series Release 113 providing guidance on valuing restricted securities.

1970

The SEC issues Accounting Series Release 118 providing general guidance on fair valuation and the board's related responsibilities.

1981

The SEC staff issues a "no action" letter to Putnam funds stating that funds may use closing market prices for foreign securities "except when an event has occurred … that is likely to have resulted in a change in [their] value."

1984

The SEC affirms the staff position in the Putnam letter in a release proposing amendments to Rule 22c-1.

1997

In response to extreme volatility in US and Asian markets, a few funds fair value price Asian securities. Some investors challenge this action, and the SEC initiates a review of fair value pricing.

1998

Following its 1997 review of fair value practices, the SEC takes steps to enhance fair value disclosure in fund prospectuses. In the release, the SEC states that in response to the 1997 market volatility, "funds appear to have relied on a longstanding position of the Commission's staff that a fund may (but is not required to) value portfolio securities traded on a foreign exchange using fair value … when an event occurs after the close of the exchange that is likely to have changed the value of the securities."

1999

The SEC staff issues a letter to ICI providing guidance on valuation responsibilities during unusual or emergency situations.

2001

The SEC staff issues a second letter to ICI explaining the concept of "significant events" in the context of fair valuing foreign securities. The letter states that market fluctuations may constitute significant events.

2003

The SEC release adopting Rule 38a-1 outlines four obligations relating to fair valuation.

2004

The SEC amends its disclosure rules to require disclosure of the circumstances under which funds will use fair value pricing and the effects of using fair value pricing. The SEC states in the adopting release that "funds are required to use fair value prices any time that market quotations for their portfolio securities are not … reliable."

2006 and 2009

The Financial Accounting Standards Board issues and codifies ASC Topic 820, which defines the term "fair value" for purposes of public accounting standards and establishes a framework for the recognition, measurement, and disclosure of fair value under US generally accepted accounting principles.

2020

The SEC adopts Rule 2a-5 to address valuation practices and the role of the board of directors with respect to fair valuation of securities held by funds and business development companies and rescinds ASR 113 and ASR 118. The SEC also adopts Rule 31a-4 relating to recordkeeping with respect to fair valuation determinations.

2021

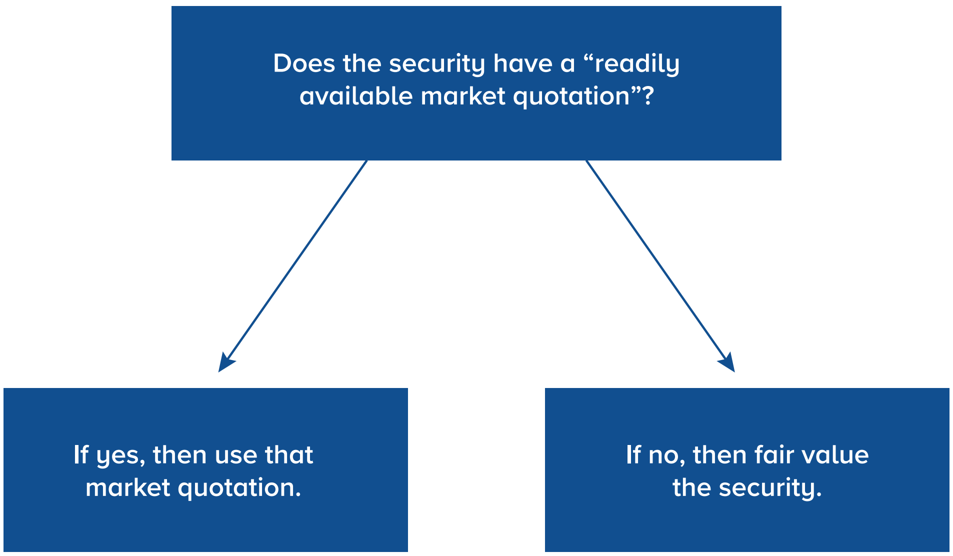
The SEC updates its Valuation Frequently Asked Questions to address questions relating to Rule 2a-5 and Rule 31a-4.

What Are a Fund's Valuation Obligations?

The Investment Company Act of 1940

Under the Investment Company Act, an instrument's "value" must be determined pursuant to the following hierarchy: securities for which market quotations are "readily available" are to be valued at market value; and all other securities and instruments are to be valued at "fair value" as determined in good faith by the fund's board of directors. The "fair value" of an instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

This sets up a simple decision tree for valuation:



In December 2020, the SEC adopted Rule 2a-5 under the Investment Company Act (Fair Value Rule or Rule). The Rule is the most significant event related to fund valuation in decades.

The adoption of the Rule was largely welcomed by fund boards. Section 2(a)(41) of the Investment Company Act requires fund boards to determine fair values in good faith in the absence of market quotations, yet, since 1940, the fund industry has become increasingly diverse and complex in terms of the asset classes in which funds invest. As a result, fair valuations have become more complicated and, in some cases, may require valuation expertise that independent trustees could not reasonably be expected to have.

The Fair Value Rule allows (but does not require) fund boards, under the circumstances described in detail in this paper, to designate a party that will provide such fair valuations, the "Valuation Designee." A Valuation Designee must be a fund's investment adviser, other than a sub-adviser, or if the fund does not have an investment adviser, an officer or officers of the fund.

The Fair Value Rule

The Fair Value Rule, like the Investment Company Act itself, reinforces the requirement that securities with a "readily available market quotation" must normally be valued at such market value. In the Fair Value Rule, the SEC for the first time provided a definition of "readily available market quotation." Under the Rule, a "readily available market quotation" is "a quoted price (unadjusted) in an active market for an identical investment that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable."

The definition of "readily available market quotation" in the Fair Value Rule aligns with the definition of Level 1[1] inputs under accounting guidance. In this respect and others, the Fair Value Rule conformed the regulatory requirements applicable to valuation to the accounting requirements applicable to valuation. Whereas, previously, lawyers, accountants, and others (such as fund advisory personnel and third-party service providers) would use different terminology to discuss valuations, the Fair Value Rule allows everyone to discuss valuation in the same vernacular.

All types of registered funds are subject to the Fair Value Rule, including mutual funds, exchange-traded funds (ETFs), closed-end funds (CEFs) and, to a certain extent, money market funds (for "shadow" pricing for stable NAV money market funds or market-based pricing for institutional floating NAV money market funds). The primary difference among them is how often they must value their holdings. For example, whereas mutual funds and ETFs must value their portfolios daily, CEFs may—but are not required to—do so; and money market funds generally apply amortized cost and/or penny-rounding valuation methodologies that are outside the scope of this paper.

The Fair Value Rule provides that, in order for a fund to determine fair value in good faith, as required by the Investment Company Act, a fund's board of directors or the board's Valuation Designee must:

1. Periodically assess and manage material risks related to determining the fair value of fund holdings (Valuation Risks);
2. Establish and apply fair value methodologies in light of a fund's Valuation Risks;
3. Test the appropriateness and accuracy of fair valuation methodologies; and
4. Establish a process for approving, monitoring, and evaluating any pricing service used and a process for price challenges.

[1] Level 1 inputs are "quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can assess at the measurement date." Level 2 inputs are "inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly." Level 3 inputs are "unobservable inputs for the asset and liability."

Significantly, the Fair Value Rule allows a fund's board of directors to designate the fund's investment adviser to perform the above four functions and perform fair value determinations for the fund. This provision of the Rule endorsed a longstanding practice with respect to fair valuation wherein advisers perform day-to-day valuations, subject to board oversight.[2]

Defining Roles and Responsibilities

The Board

Under the Fair Value Rule, boards are empowered to determine to be directly involved in the fair valuation process or designate the fund adviser (or, if none, fund officer(s)) as Valuation Designee, then oversee the fair valuation process through the Valuation Designee. The vast majority of boards have determined to designate a Valuation Designee and oversee the process. As a result, such directors' involvement in the fair valuation process typically consists of approving fund valuation policies and procedures and overseeing their implementation through the Valuation Designee. Neither the board nor the individual board members are involved in day-to-day valuation decisions. Yet the important role of the board in fair valuation has not been diminished. To the contrary, in adopting the Rule, the SEC emphasized the importance of active oversight by the board of the fair valuation process.[3]

The Adviser and Valuation Committee

As the Valuation Designee, a fund adviser plays a critical role in the fair valuation process. The adviser often fulfills its valuation responsibilities through a valuation committee.

Before the Fair Value Rule, practices varied widely as to the precise role and composition of the valuation committee. Historically, certain valuation committees may have included directors. After the Rule's adoption, it is uncommon for directors to serve as valuation committee members.

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[2] In the adopting release for the Rule, the SEC advised that "[b]oards should approach their oversight of the performance of fair value determinations by the valuation designee of the fund with a skeptical and objective view that takes account of the fund's particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determination process, and the skill and resources devoted to it. Further, in our view appropriate oversight cannot be a passive activity."

[3] "We believe that boards are not providing appropriate oversight if they simply rely on information presented to them without actively probing it, asking questions, and seeking relevant information, particularly when there are red flags or other indications of problems… 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 valuation designee and other service providers involved in the determination of fair values."

The members of the valuation committee are often identified in the adviser's (fair) valuation policies and procedures unless the committee has a charter. Valuation committees may include personnel with valuation expertise, including investment professionals, such as Chief Investment Officers or financial analysts, but they also routinely include personnel from trading, operations, compliance and/or legal, as well as representatives from the fund's administrator. Senior accounting personnel at the administrator, in particular, tend to serve on valuation committees, particularly if they serve as the Principal Financial Officer or Treasurer of a fund. In addition, the fund and adviser chief compliance officer and other compliance personnel may serve on valuation committees due to their important role in ensuring that a fund's valuation procedures are being followed and are reasonably designed to prevent the fund from violating the federal securities laws. Valuation committees do not include representatives of the fund's auditor for a variety of reasons, including the importance of safeguarding the independence of the auditor.

Under the Fair Value Rule, Valuation Designees must "reasonably segregate…fair value determinations from the portfolio management of the fund." As a result, as members of a valuation committee, portfolio managers can neither determine nor "effectively determine by exerting substantial influence on" fair valuations. The Rule includes this reasonable segregation requirement in order to mitigate any conflict of interest that portfolio managers or persons in related functions may have with respect to valuations in light of the impact of valuations on performance.

While valuation committees are likely involved in the daily identification, assessment, and resolution of fair value matters, they may also have other related responsibilities. For example, they may meet periodically to review fair valuations, evaluate testing results, consider the need for enhancements to the policies and procedures based on new product types, and conduct due diligence on pricing services.

The Administrator

All funds calculate their NAV periodically, and mutual funds and ETFs do so daily. In order to calculate NAV, each fund holding must be assigned a value, consistent with the Investment Company Act requirements and, in the case of fair valuations, the Fair Value Rule. Fund administrators are typically responsible for obtaining such values—both readily available market prices and fair valuations—from the sources authorized by the fund's policies and procedures to provide them. Generally speaking, administrators do not exercise independent judgment regarding the values applied to fund holdings. Rather, if a valuation requires judgment, the administrator contacts the adviser, which may then convene a meeting of the valuation committee, to provide direction to the administrator on the value to be applied. Once each fund holding has a value, the administrator calculates and publishes the fund's NAV.

Sub-Advisers

Sub-advisers are not permitted to act as Valuation Designees under the Rule and do not typically have any significant day-to-day responsibility for the valuation of fund investments. However, the adviser may consult sub-adviser personnel from time to time regarding particular fair valuations.

Pricing Services

Pricing services may provide both readily available market prices and fair valuations to funds. For example, funds routinely obtain prices of exchange-traded equities through pricing services. When such prices are "readily available market quotations" within the meaning of the Rule, they are not fair valuations. However, pricing services also provide fair valuations, including "evaluated prices" on fixed income securities and other instruments, such as over-the-counter options.

Pricing services may specialize in providing evaluated prices or other fair valuations on different types of instruments. Valuation Designees may consider these specializations in choosing pricing services for a fund. A fund complex that invests in many different asset classes may use more than one pricing service to obtain the values that are reflected in fund NAVs.

The Fund Auditor

A fund's financial statements must be audited annually by an independent public accountant registered with the Public Company Accounting Oversight Board (PCAOB). An important component of the auditing process is the auditor's testing of values assigned to a fund's investments. Pursuant to ASR 118, historically, fund auditors have independently assessed the value assigned to each fund holding as of the end of the fund's fiscal year. In connection with the Fair Value Rule, ASR 118 was rescinded. As a result, going forward auditors may choose to independently assess only a sample of fund holdings, provided such sampling is consistent with applicable accounting standards. Practices may develop over time and vary by, among other considerations, auditor or the types of investments held by a fund.

Assessing and Managing Valuation Risks

Funds are required to periodically assess any material risks associated with the fair value determination of investments (Valuation Risks), including material conflicts of interest, and manage any identified Valuation Risks.[4] In that regard, the Rule is designed to provide a board or Valuation Designee with the flexibility to determine the types of Valuation Risks that are relevant to a particular fund's investments and to determine to weigh certain Valuation Risks more heavily than others.

The requirement to assess and manage risks generally requires the board or Valuation Designee to take into account those investments that the fund reasonably expects to purchase in the reasonably near term. However, a board or Valuation Designee is not expected to identify all the types of investments a fund will hold in the future or every Valuation Risk associated with each possible future investment. As with other aspects of a fund compliance program, the assessment of Valuation Risks may evolve.

As discussed above, funds must establish and apply fair value methodologies. This means a board or Valuation Designee must select and apply in a consistent manner an appropriate methodology or methodologies for determining (and calculating) the fair value of fund investments, taking into account a fund's Valuation Risks. In addition, a board or Valuation Designee must periodically review the appropriateness and accuracy of the methodologies selected and make any necessary changes as well as monitor for circumstances that may necessitate the use of fair value (discussed in detail below). Although not explicitly prescribed by the Fair Value Rule, most funds establish fair value methodologies and provide for their testing by adopting appropriate policies and procedures or having the Valuation Designee's policies and procedures approved by the board.

[4] The SEC adopting release for the Rule contains a non-exhaustive list of examples of sources and types of valuation risks for funds to consider.

Establishing Valuation Policies and Procedures

In the adopting release for the Rule, the SEC states that the requirement to adopt valuation policies and procedures is inherent in Rule 38a-1 under the Investment Company Act (Compliance Rule).[5] The SEC also clarifies in the release that if a fund has a Valuation Designee, then under 38a-1 the board should approve the applicable fair valuation policies and procedures as adviser policies and procedures rather than fund policies and procedures.

A fund's valuation policies and procedures may take various forms. For example, some boards may approve fund valuation policies and procedures that describe the role of the fund accountant with respect to obtaining readily available market prices and calculating NAV as well as adviser fair valuation policies and procedures that address fair valuations. Other boards may approve one set of policies and procedures that assign the fair valuation functions to the fund's adviser as the Valuation Designee. Other boards may take still other approaches, which may be appropriate under the circumstances.

Fund valuation procedures typically describe the specific valuation techniques and methodologies that will be used by the fund, including methodologies for particular types of securities and other investments. To the extent a fund may be able to automate certain fair valuation processes involving techniques based on objective criteria (e.g., quantitative models to fair value foreign equity securities), the procedures will identify the techniques, describe how and when they will be used, and provide a process for review of the resulting valuations by the board, or if applicable, the Valuation Designee.

[5] Rule 38a-1 requires the fund's chief compliance officer to provide an annual report to the fund's board that addresses the operation of the valuation policies and procedures, including any material changes to these policies and procedures, which may include changes to methodologies or valuation practices.

Monitoring for Circumstances that May Require Fair Value Pricing

Funds are required to monitor for circumstances that may necessitate the use of fair value prices. Generally, there are two broad circumstances in which fair valuation may be considered: 1) the lack of a readily available market quotation; and 2) the occurrence of a significant event.

The Lack of a Readily Available Market Quotation

Funds should monitor for the following types of circumstances where there may not be a readily available market quotation, or a market quotation is not reliable (and hence, not readily available). Whether a particular market quotation is readily available is highly fact specific.

» ***Markets closing before 4:00 p.m. Eastern Time.*** Many foreign markets are closed at 4:00 p.m. Eastern Time when most funds cut off orders and begin to calculate their NAVs. As a result, market quotations for securities principally traded on these exchanges may no longer be current at that time.[6]

» ***Trading halts.*** The last market quotation for a security that was subject to a trading halt may not be reliable, if the halt remains in place at the end of the trading day.

» ***Events that unexpectedly close entire markets.*** Natural disasters, power blackouts, pandemics, global conflicts, or similar major events could force a market to close unexpectedly.

» ***Scheduled market holidays.*** A scheduled holiday in a market (other than the NYSE) could call into question whether securities that principally trade on that market have readily available market quotations.

» ***The absence of trading.*** The absence of trading in an individual security could raise the issue of whether that security has a readily available market quotation. This may be a common occurrence with respect to some small capitalization stocks and many fixed income securities.

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[6] Closing prices for securities that trade primarily on foreign markets, such as the Tokyo Stock Exchange, may be established as many as 15 hours before 4:00 p.m. Eastern Time.

Significant Events

If a fund invests in securities that trade in foreign markets, the board or Valuation Designee may identify and monitor for "significant events." Prior SEC staff guidance that was withdrawn in connection with the adoption of the Rule defined a "significant event" as one that would materially affect the value of the security and therefore may suggest that the market quotation is not reliable. The Fair Value Rule does not use the term "significant event," and continuing to do so may be seen as technically inconsistent with the Rule.

However, in the adopting release for the Rule, the SEC states:

> [I]f a fund invests in securities that trade in foreign markets, the board or valuation designee, as applicable, generally should identify and monitor for the kinds of significant events that, if they occurred after the market closes in the relevant jurisdiction but before the fund prices its shares, would materially affect the value of the security and therefore may suggest that market quotations are not reliable.

Further, the fund industry's approach with respect to significant events has not changed dramatically as a direct result of the Rule. For US funds that hold foreign securities, the time lag between the foreign market close and the funds' calculation of NAV may cause them to fair value foreign securities by applying adjustment factors provided by pricing services to the securities' local market prices. Pricing services use market-based proxies, such as market indices and historical correlation data, to adjust the values of foreign securities for market events that occurred between the time that the relevant foreign market closed and 4:00 p.m. Eastern Time, when most funds calculate NAV.

A fund that uses a pricing service in the fair valuation process for foreign equities must consider when and how it will use the information provided by the pricing service. Some funds establish a "trigger" to determine when to fair value.[7] These funds take into account the pricing service's fair value adjustment on days when their trigger has been exceeded, and use closing market prices on other days.

Triggers across the industry vary. While some funds establish a trigger based on, for example, an intra-day market move of 25 to 100 basis points in a domestic index, other funds apply a "no trigger" or "zero trigger" approach—meaning, they apply a pricing service's fair value adjustment every day. Still other funds, particularly exchange-traded funds that conduct substantially all of their transactions in kind, may not use a trigger at all in light of the reduced risks of dilution and market timing as a result of transacting in kind.

[7] A "trigger" is a specified level of price change in a domestic market or asset that is used to indicate the need to fair value.

Disclosure of Fair Valuation Policies and Procedures

The SEC requires funds to explain in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. Instructions to the registration form for funds generally state that the disclosure should be brief, and that funds are not required to provide detailed information about their fair value pricing methodologies and formulas. The challenge typically lies in providing sufficient information to be accurate without including excessive detail that third parties may use to the detriment of the fund.

Reviewing and Testing Fair Valuations

Funds are required to test the appropriateness and accuracy of the methodologies used to determine fair values. The frequency and nature of testing will likely vary depending on the type and amount of investments held by the fund. This requirement is designed to help ensure that the selected fair value methodologies are appropriate and that adjustments to the methodologies are made when necessary.

The testing requirement of the Rule is designed to permit funds to assess the operation of particular valuation methodologies in specific situations and over time, so that those methodologies can be adjusted going forward, as appropriate in light of changing conditions or experience. In this regard, it is important to understand that the primary goal of testing is not to assess the accuracy of any particular valuation.

The board or Valuation Designee must identify the testing methods to be used and the minimum frequency of such testing methods. The SEC has identified calibration and back-testing as examples of useful testing methods but has not prescribed any particular methodology.

Calibration

Calibration is the process for monitoring and evaluating whether there are material differences between the actual price the fund paid to acquire portfolio holdings that were fair valued, and the prices calculated for those holdings by the fund's fair value methodology at the time of acquisition. Calibration can assist in assessing whether the fund's valuation methodology reflects current market conditions, and whether any adjustments to the valuation technique are appropriate.

Back-Testing

Back-testing involves a comparison of the fair value assigned to a fund's investment against observed transactions or other market information, such as quotes from dealers or data from pricing services. One common form of back-testing is "disposition analysis," which compares fair value as determined using a fair value technique with the price obtained for the security upon its disposition by the fund.

Overseeing Pricing Services

The Fair Value Rule requires the oversight and evaluation of pricing services. For funds that use pricing services, the board or Valuation Designee must establish a process for approving, monitoring, and evaluating each pricing service used. This requirement reflects the critical role that pricing services play in the valuation process as well as existing vendor due diligence practices.

While the Valuation Designee typically determines the pricing source (e.g., pricing service) for each asset class, a pricing service most often establishes the methodology for calculating fair values and calculates fair values. Often funds will use different pricing services for different types of instruments and may use multiple pricing services per instrument type (e.g., primary and secondary sources) to ensure coverage in the event that a primary pricing source fails to provide a price. A secondary pricing source can also serve as an indication of the reliability of prices provided by the primary pricing source.

Price Challenges and Overrides

The Rule requires funds to establish a process for initiating price challenges. Such a process generally should outline the circumstances under which a price challenge should be initiated. In addition, the specific personnel with duties related to price challenges should be identified, including those with the authority to override a pricing service's price, as well as the roles and responsibilities of such persons. The SEC views price challenges and overrides as a critical component of pricing service oversight by the board or Valuation Designee, as applicable.

Back-Testing by and of Pricing Services

Funds that use a pricing service in the fair valuation process should consider the extent of the pricing service's own back-testing in determining how the fund should test the pricing service's valuation methodologies. As part of its due diligence prior to the engagement of a particular pricing service, the board or Valuation Designee should take steps to understand the nature and frequency of the back-testing that the pricing service will perform and the modifications that the pricing service may make as a result of that testing. In addition, the board or Valuation Designee may consider periodically performing its own back-testing on prices provided by pricing services.

Board Reporting and Recordkeeping

Board Reporting

To facilitate a board's oversight of the fair valuation process, the Fair Value Rule requires the Valuation Designee to make certain written reports to the board on a quarterly, annual, and prompt basis.

The Rule requires ***prompt reporting*** on matters that materially affect a fair valuation, no later than five business days after the valuation. Matters that materially affect a fair valuation include a significant deficiency or material weakness in the design or effectiveness of the Valuation Designee's fair value determination process and material errors in the calculation of NAV.

The Rule requires ***quarterly reporting*** on material fair value matters from the preceding quarter and any fair valuation-related matter as to which the board has requested periodic reporting.

The Rule requires ***annual reporting*** on the adequacy and effectiveness of the Valuation Designee's fair valuation process, including, at a minimum, a summary of the results of the Valuation Designee's testing of applied fair value methodologies and an assessment of the adequacy of resources allocated to the fair valuation process, including any changes in personnel involved in the process.

Recordkeeping

Rule 31a-4, adopted alongside the Fair Value Rule, contains the recordkeeping requirements associated with fair valuation determinations. Appropriate documentation to support a fair valuation determination consists of the records related to the fund or Valuation Designee's initial due diligence investigation prior to selecting a pricing service, records from its ongoing monitoring and oversight of the pricing services, and work papers created by the Valuation Designee while overseeing pricing services or testing fair value methodologies.

Rule 31a-4 requires a fund to maintain appropriate documentation to support fair value determinations for a period of six years, and the first two years in an easily accessible place, *unless* the board has designated the performance of fair valuation determinations to the fund's investment adviser as Valuation Designee, in which case the investment adviser is responsible for maintaining the records.

In cases where the board has designated the performance of fair valuation determinations to a Valuation Designee, the Valuation Designee must maintain copies of reports and other information provided to the board, which must include a specified list of the investments or investment types for which the Valuation Designee has been designated.

If the board has not designated the performance of fair valuation determinations to the Valuation Designee, the fund is responsible for maintaining all appropriate documentation.

Appendix A

Statutory and Regulatory Framework

- Investment Company Act Sections 2(a)(41), 22(c), 22(e), and 23(b)
- Investment Company Act Rules 2a-4, 2a-5, 2a-7, 22c-1, Rule 22e-2, 31a-4, and 38a-1

  Accessible through the SEC's Division of Investment Management website, available at www.sec.gov/divisions/investment.shtml

White Papers

- *SEC Valuation and Liquidity Guidance for Registered Investment Companies* (2015)
  - Volume 1
    www.ici.org/doc-server/pdf/pub_11_valuation_volume1.pdf
  - Volume 2
    www.ici.org/doc-server/pdf/pub_09_valuation_volume2.pdf
- *Fund Valuation Under the SEC's New Fair Value Rule* (December 2021)
  www.ici.org/files/2021/21-ppr-fund-valuation-primer.pdf

SEC Guidance

- October 10, 2008, and August 19, 2010, and SEC staff letters to ICI
  - October 2008 SEC Staff Letter
    www.sec.gov/divisions/investment/noaction/2008/ici101008.htm
  - August 2010 SEC Staff Letter
    www.sec.gov/divisions/investment/noaction/2010/ici-nrsro081910.htm
- SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, SEC Press Release No. 2008-234 (September 30, 2008)
  www.sec.gov/news/press/2008/2008-234.htm
- Division of Investment Management, Staff Responses to Questions about Rule 30b1-7 and Form N-MFP (July 29, 2011)
  www.sec.gov/divisions/investment/guidance/formn-mfpqa.htm
- Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014) (noting that certain portions were later rescinded in IC-34128)
  www.sec.gov/files/rules/final/2014/33-9616.pdf

- Good Faith Determinations of Fair Value, Investment Company Act Release No. 34128 (December 3, 2020) (adopting Investment Company Act Rule 2a-5 and rescinding certain portions of IC-31166)
  www.sec.gov/files/rules/final/2020/ic-34128.pdf

- 2014 Money Market Fund Reform Frequently Asked Questions (last updated February 17, 2021)
  www.sec.gov/investment/2014-money-market-fund-reform-faq

- Good Faith Determinations of Fair Value: A Small Entity Compliance Guide (last updated February 26, 2021)
  www.sec.gov/resources-small-businesses/small-business-compliance-guides/good-faith-determinations-fair-value-small-entity-compliance-guide

- Valuation Frequently Asked Questions (last updated March 18, 2021)
  www.sec.gov/investment/valuation-faq

Appendix B

Notable SEC Enforcement Actions

- *Parnassus Investments* (September 3, 1998) (alleging respondents overvalued open-end fund portfolio by not applying a restricted share discount as part of fair valuation process)
- *Piper Capital Management* (August 6, 2003) (alleging respondent manipulated the fund's NAV by overvaluing holdings in collateralized mortgage obligations)
- *The Heartland Funds* (alleging overvaluing of fund portfolios by "smoothing out" decreases in bond values and thus not basing prices on the bonds' good faith fair values)
  - FT Interactive Data (December 11, 2003) (pricing service)
  - Jon D. Hammes, et al. (December 11, 2003) (former independent directors)
  - Heartland Advisors (January 25, 2008) (adviser, adviser personnel, non-independent director)
- *Van Wagoner Capital Management* (August 26, 2004) (alleging respondents undervalued the funds' NAVs by lowering valuations for private securities holdings to comply with a 15 percent limitation on illiquid securities)
- *Evergreen Investment Management Company* (June 8, 2009) (alleging adviser overvalued fund holdings in mortgage-backed securities by not taking into account certain readily available information when recommending valuations and made selective disclosures to investors)
- *Morgan Asset Management* (June 22, 2011) (alleging inaccurate NAVs were caused by undocumented and arbitrary price adjustments of specific holdings which did not reflect fair value, and failure of funds to implement fair valuation procedures)
- *UBS Global Asset Management* (Americas) (January 17, 2012) (alleging adviser failed to properly value holdings in fixed-income securities in accordance with the fair valuation procedures, resulting in inaccurate NAVs and causing funds to violate their fair valuation procedures)
- *KCAP Financial, Inc.* (November 28, 2012) (alleging business development company failed to record and report its assets' fair values in conformity with Financial Accounting Standards Board Statement of Financial Accounting Standards 157 – Fair Value Measurements and Generally Accepted Accounting Principles by not accounting for certain market-based activity)

- *Oppenheimer Asset Management* (March 11, 2013) (alleging adviser's deficient written policies and procedures contributed to misrepresentations and omissions made to potential investors relating to asset values)
- *Calvert Investment Management* (October 18, 2016) (alleging adviser improperly valued bond holdings, leading to incorrect fund NAVs, and the remediation effort did not precisely calculate fund and shareholder losses in accordance with the NAV error correction procedures)
- *Pacific Investment Management Company* (December 1, 2016) (alleging adviser overvalued fund's portfolio by pricing odd lot positions at a pricing vendor's price without a reasonable basis for doing so, causing an overstated NAV, and alleging adviser's pricing procedures were not reasonably designed)
- *Semper Capital Management* (April 28, 2020) (alleging adviser overvalued fund portfolio due to overstated odd lot pricing, which caused an overstated NAV)
- *AlphaCentric Advisors LLC* (June 3, 2022) (alleging adviser failed to adopt and implement procedures related to valuation and oversight of role of portfolio manager and sub-adviser in valuing fund securities in connection with odd lot pricing)
- *Infinity Q* (alleging that adviser, through its chief investment officer, engaged in a fraudulent scheme to inflate assets held by open-end fund and hedge fund by manipulating valuation models and altering inputs, leading to incorrect NAVs)
  - James Velissaris (February 17, 2022) (chief investment officer)
  - Scott Lindell (September 30, 2022) (chief risk and compliance officer)
  - Infinity Q Diversified Alpha Fund (November 10, 2022) (mutual fund)
  - Infinity Q Capital Management (June 16, 2023) (adviser)
- *Macquarie Investment Management Business Trust* (September 19, 2024) (alleging adviser overvalued illiquid odd lot collaterized mortgage obligations by using prices from a third-party pricing service that were intended only for institutional round lots, without reasonable basis to believe the odd lots could be sold at those prices)

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