CLIENT MEMORANDUM

SEC Issues Valuation Guidance

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The Securities and Exchange Commission recently issued valuation guidance for *all* registered investment companies and business development companies embedded in the adopting release relating to money market reform.[1] Although the guidance, which relates primarily to the use of amortized cost valuation for debt securities with remaining maturities of 60 days or less and reliance on pricing services for evaluated prices of debt securities, was included in the release adopting amendments to Rule 2a-7 under the Investment Company Act of 1940, its applicability clearly is not limited to money market funds. The guidance imposes a substantial condition on the use of amortized cost valuation of debt securities for all funds and articulates a fund board's responsibilities in overseeing the use of evaluated prices supplied by third party pricing services.

Amortized Cost Valuation for Securities with Remaining Maturities of 60 Days or Less

The SEC used the adoption of amendments to Rule 2a-7, which governs the operation of money market funds, as an opportunity to provide guidance to all registered investment companies and business development companies on the use of amortized cost valuation for debt securities with remaining maturities of 60 days or less. Registered investment companies and business development companies are permitted to use amortized cost to value such debt securities, but

[1] Money Market Fund Reform; Amendments to Form PF, 1940 Act Release No. 31,166 (Jul. 23, 2014) (the "Adopting Release").

only if the fund "can reasonably conclude, at *each time* it makes a valuation determination, that the amortized cost value of the portfolio security is *approximately the same* as the fair value of the security as determined without the use of amortized cost valuation."[2] In this regard, according to the SEC, "[e]xisting credit, liquidity, or interest rate conditions in the relevant markets and issuer specific circumstances *at each such time* should be taken into account in making such an evaluation."[3] The SEC emphasized that it would be inappropriate for a fund to continue to value debt securities with remaining maturities of 60 days or less at amortized cost without review until an explicit change in relevant circumstances (such as market conditions or issuer-specific factors) occurs.

The guidance thus effectively requires a fund holding debt securities with maturities of 60 days or less to value them using market-based data (*i.e.*, "shadow price" them) every day it calculates net asset value and use the market price if it is not "approximately the same"[4] as the amortized cost price. The SEC suggested that funds should design their valuation policies and procedures "to ensure that the fund's adviser is actively monitoring both market and issuer-specific developments that may indicate that the market-based fair value of a portfolio security has changed during the day, and therefore indicate that the use of amortized cost valuation for that security may no longer be appropriate."[5]

Noting the absence of an active trading market for certain types of debt securities, including certain money market instruments, the SEC emphasized that fair valuation must take into account current market conditions for thinly traded securities. The Adopting Release states that "[a]s a general principle, the fair value of a security is the amount that a fund might reasonably expect to receive for the security upon its current sale."[6] As a result, "funds 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."[7] This statement, together with the shadow pricing requirement described above, may effectively limit the use of amortized cost valuation during the last 60 days until maturity.

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2 *See* Adopting Release at n. 878 and accompanying text (footnotes omitted) (emphasis in original).

3 *Id.* (emphasis added). The SEC noted, however, that "in some circumstances (*e.g.*, intraday), a fund may rely on the last obtained market-based data to assist it when valuing its portfolio securities using amortized cost." *Id.*

4 The SEC did not provide any guidance as to the meaning of "approximately the same."

5 *Id.*

6 *Id.* at n. 891 and accompanying text.

7 *Id.* at n. 892 and accompanying text.

Reliance on Pricing Services

The Adopting Release articulates the SEC's view that evaluated prices provided by pricing services[8] "are not, by themselves, 'readily available' market quotations or fair values" as required by the 1940 Act.[9] Accordingly, fund boards must determine whether an evaluated price constitutes a fair value for a portfolio security.[10] The Adopting Release states that the duty of a fund's directors to determine whether an evaluated price constitutes "fair value" cannot be delegated to anyone else, although the directors "may appoint others, such as the fund's investment adviser or a valuation committee, to assist them in determining fair value, and to make the actual calculations pursuant to the fair valuation methodologies previously approved by the directors."[11]

The SEC provided guidance on factors that a board may take into account, and the process that a board may follow, in determining to use a pricing service's evaluated prices. Specifically, to determine that an evaluated price constitutes fair value, fund boards

> may want to consider the inputs, methods, models, and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change. In choosing a particular pricing service, a fund's board may want to assess, among other things, the quality of the evaluated prices provided by the service and the extent to which the service determines its evaluated prices as close as possible to the time as of which the fund calculates its net asset value. In addition, the fund's board should generally consider the appropriateness of using evaluated prices provided by pricing services as the fair values of the fund's portfolio securities where, for example, the fund's board of directors does not have a good faith basis for believing that the pricing service's pricing methodologies produce evaluated prices that reflect what the fund could reasonably expect to obtain for the securities in a current sale under current market conditions.[12]

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8 The Adopting Release distinguishes between matrix pricing, in which "values are derived from a range of different inputs, with varying weights attached to each input, such as pricing of new issues, yield curve information, spread information, and yields or prices of securities of comparable quality, coupon, maturity, and type," and evaluated prices from third-party pricing services, "which may take into account these inputs as well as prices quoted from dealers that make markets in these instruments and financial models." *Id.* at n. 881-882 and accompanying text.

9 *Id.* at n. 895 and accompanying text.

10 *Id*. at n. 896 and accompanying text.

11 *Id.* at n. 891 and accompanying text.

12 *Id.* at n. 899 and accompanying text.

As fund boards may not use uniform practices to evaluate pricing services and the prices that they provide, this guidance suggests that some fund boards may need to enhance their oversight of the use of pricing services. Funds and boards should review their valuation procedures for consistency with this guidance. Funds may also wish to review how they disclose the role of the board in the valuation process and the use of evaluated prices.

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