

A Modern Approach to Good Faith Determination of Fair Value:

NEW GUIDANCE & IMPLICATIONS FOR FUND BOARD MEMBERS AND ADVISERS



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On April 21, 2020, the Securities and Exchange Commission ("SEC") proposed a rule ("Proposed Rule") setting forth a framework and minimum standards for boards of directors in fair valuing investments without readily ascertainable market values. The Proposed Rule provides much needed guidance to boards of directors, investment advisers to fund boards, independent third-party valuation services, auditors, market participants and investors.¹

SEC Chairman Jay Clayton noted in a Press Release accompanying the Proposed Rule, "The way a fund values its investments is critical to our Main Street investors". Release of the Proposed Rule during a period of unprecedented market volatility caused by the Covid Crisis reminds all of the importance of fair value determinations to investors, including "main street investors".

It has been 50 years since the last major guidance of the SEC relating to fund valuation governance practices. In 1969, at the time SEC issued its last major valuation guidance for funds, the SEC noted that funds subject to regulation held more than \$4.2 billion in securities.² That number now seems quaint.

Since 1969, fund managers and boards relied on a combination of corporate fiduciary law, Sarbanes-Oxley, no-action letters, and SEC staff speeches to set minimum standards of board governance. As a result of inspection exams, the SEC has observed a wide continuum of board governance in how funds oversee the fair value process. Modernization is clearly overdue considering the explosive growth of private capital funds in the last 50 years.

While the Rule is a mere 4 pages, the well written background commentary of 135 pages provides excellent and well considered insight into a new "principles based" framework of evaluating and reporting on fair value determination for assets without readily ascertainable market values. This Note provides context to the overarching goals of the Proposed Rule—providing fund boards with the minimum (not maximum) expectations required to fulfill their fiduciary responsibilities in determining fair value.

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HIGHLIGHTS AND IMPLICATIONS

We expect the Proposed Rule will bring about both subtle as well as significant changes in behavior among fund boards, investment advisers, auditors and third part valuation providers.

For Boards of Directors—Greater degree of oversight responsibility

1. Boards may explicitly “assign” the determination of fair value to the fund’s investment adviser. The Proposed Rule does not relieve a board from traditional role of oversight. In practice, the Rule requires greater, not less, oversight of and involvement in the valuation process.

2. Boards are responsible for ensuring avoidance of a broad range of potential conflicts of interest both within the investment adviser and outside services advisers may engage, particularly in circumstances where a person providing a valuation has a financial stake in the outcome of the determination.

3. Boards that assign fair valuation of fund investments to investment advisers (which we expect to be the most common governance model) cannot delegate responsibility for determination of fair value of investments and the policies and processes by which investment advisers make such determination. In fact, the requirement that advisers and others regularly (and in some cases, within 3 days) report on weaknesses in policies, procedures and methods used in calculating fair value enhances the role of the board of directors, as the board will have responsibility for responding to such reports.

4. Boards must both request and review information as “may be deemed necessary to be fully informed of the adviser’s process[es]”. This requirement reduces any unintended implication that a board may “outsource” fair value determination.

5. Boards are required to both inquire about and take steps to understand any material matters affecting valuation, whether the board is made aware of material matters by the adviser. Boards cannot merely react to what their members receive from advisers. Boards must continue to remain current to fulfill their oversight duties.

6. Boards that assign duties must evaluate the qualifications of those to whom it assigns responsibilities. The SEC seeks to avoid “rubber stamping” by advisers or services they employ.

7. The SEC realizes that effective information is a critical part of a board’s oversight of an adviser. Therefore, boards must receive relevant and tailored information to ensure they have sufficient insight and data to exercise their oversight. This information must be timely and address the fund’s performance, provide for sensitivity analyses, explain material valuation risks, identify significant changes to valuation methodologies, provide backtesting of prior valuation models, as well as address many other important valuation matters.

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For Investment Advisors—Greater transparency, record keeping and avoidance of conflicts of interest

1. Investment advisers are responsible for an enhanced level of reporting to the board. Investment advisers are required to report on process that materially or could have materially affected fair value of an investment. This responsibility entails several stated and implicit “sub duties” including documenting and reporting valuation risks, changes to methodologies, and process changes in the employment of pricing services.

2. Investment advisers are responsible for reporting any significant process weakness in determining fair value. Obviously, the duty to report such process weakness requires an investment advisor to be aware of any such weakness and suggests the importance of also interacting with the fund’s external auditor.

3. Investment advisers are required to specify the titles and responsibilities of those tasked in fair value determination. Clearly, this is a warning against a conflict of interest between the role of the portfolio manager and the role of the person making determinations of fair value.

4. Investment advisers are responsible for responding to board requests. Since boards are required to raise issues relating to valuation, whether such information relates to matters provided by the adviser, the adviser must promptly respond to any concerns raised by the board. The importance of documenting these interactions cannot be overstressed.

5. Investment advisers must continue to adopt written policies and procedures and document models and methods of analysis. While the Proposed Rule can be read to codify existing best practices, it may also be read to put advisers and others on notice that valuation techniques, models and forms of analysis that do not conform to written policies and procedures will be subject to a high level of scrutiny.

For Independent Valuation Services Providers—Recognition of consistency in models, techniques and use of pricing services

1. Valuation services firms have long provided independent valuation services to funds and others with an interest in unbiased reporting. The Proposed Rule implicitly recognizes the importance of valuation advice by those who have no financial interest in the fair value determination.

2. Valuation service providers will be encouraged under the Proposed Rule to maintain a full and complete list of the skills, experience and background of all personnel engaged in providing services to funds or advisers.

3. Valuation service providers should continue to consider their own independence from conflicts of interest and their own expertise in evaluating complex assets as both advisers, funds and service providers consider the implementation of the Proposed Rule.

4. The Rule is principle based and does not require specificity regarding testing methods, processes for selecting pricing services or tools employed to assist in determination of fair value. The cascade of responsibility and oversight flows from the Board to the Adviser or sub-Adviser to the independent valuation service provider and those whose services it may use. As the independent valuation services provider is engaged to assist in determination of fair value, it remains incumbent for such providers to be aware of and responsive to the requirements of the adviser.

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CONCLUSION

The comment period for the Proposed Rule expires on July 21, 2020. If adopted, there will be a one-year transition period for funds to comply with the requirements of the Proposed Rule.

The long-awaited Rule does much more than codify best practices of funds and investment advisers. The Rule sets forth a detailed framework for transparency in determining fair value for the benefit of investors.

As Commissioner Peirce noted in the Public Statement accompanying the release of the proposed Rule—"The timing of this proposal during the COVID-19 crisis and attendant economic and market instability affords us the opportunity to learn from the fresh-in-mind difficulties that funds and other market participants confront in valuing securities during highly volatile market conditions".

This article is a brief summary of the Proposed Rule. The Proposed Rule and commentary is extensive. We believe the SEC intentionally provided more guidance and thought than usual as it seeks to address significant ambiguity in rules and practices employed by the industry in determining fair value of investments. Lincoln International, as one of the leading firms serving the valuation needs of private equity and private credit funds, will be pleased to discuss the Proposed Rule with you at your convenience. Please contact any of the undersigned to discuss the implications of the Proposed Rule on your fund".

¹ Good Faith Determinations of Fair Value, SEC Release IC-33845 (April 21, 2020)

² Accounting Series Release No. 113 (October 11, 1969)

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