The regulatory framework governing fair valuation practices in the U.S. hasn’t undergone any substantial change for the best part of a decade, although thanks to a recently proposed rule by the U.S. Securities and Exchange Commission, that is all about to change.

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There are two words more than any others that currently drive and are now synonymous with regulatory reform across the capital markets: investor protection. Those two words provided the impetus for and underpinned much of the Dodd–Frank Wall Street Reform and Consumer Protection Act, enacted in July 2010 in the wake of the global financial crisis, while Mifid II, the other globally significant regulation introduced in the last two decades, was similarly conceived as a means of reinforcing investor protection across the pan-European marketplace. Both mandates changed the financial services industry as we know it and both centered ostensibly on regulators’ (and lawmakers’) determination to provide greater levels of transparency and better checks and balances for the benefit of the man in the street.

It has been almost a decade since the framework governing how US-based investment managers assign fair values to the securities they hold was last amended. November 2007 saw the introduction of ASC 820—initially known as FAS 157—and then four years later in May 2011, IFRS 13 entered the statute books, both of which provide investment managers with a detailed guide for determining fair value. Much has been written about the valuations vagaries facing the industry and the means of satisfactorily addressing those challenges, many of which are covered in Fair valuations – what lies beneath, a Refinitiv-sponsored whitepaper published in May 2020.

### Good Company

If you work on the buy side and haven’t yet heard of the Securities and Exchange Commission’s (SEC’s) proposed rule 2a-5, you’re probably in good company. But that is likely to change in the foreseeable future as pretty much all US-based investment managers will need to familiarize themselves with the rule and the significant changes it is set to introduce when it finally enters the statute books at some yet-to-be-determined point in the future. The fact that the SEC is yet to decide on a concrete date for rule 2a-5’s implementation should in no way be interpreted as it merely testing the regulatory waters. On the contrary, this rule is likely going to happen, and when it does, it’ll change everything.

“The way a fund values its investments is critical to our Main Street investors,” said SEC Chairman, Jay Clayton, in an April 21, 2020 press release on the Commission’s website outlining its proposal for the modernization of the framework that governs how investment managers under its purview value the securities they hold, and by association, the portfolios they manage. “It affects the fees they pay, the returns they receive, and the value of the fund shares they hold,” he said.

“Today’s proposal would improve valuation practices, including oversight, thereby protecting investors and improving market efficiency, integrity and fairness.”

The last time the SEC comprehensively addressed valuation practices was 50 years ago under the Investment Company Act by way of a pair of rules issued in 1969 and 1970. Clearly, this latest move was more a matter of when and not if the Commission was going to overhaul the valuations marketplace. However, as the industry witnessed with Dodd–Frank and Mifid II, certain aspects of those regulations have now evolved into global best practices, and in all likelihood regulation 2a-5 will be similarly adopted by the industry. In other words, it is entirely reasonable to expect much of the substance of 2a-5 to be embraced by large numbers of investment managers, irrespective of their location and their competent regulatory authorities.

### Rules-based

The original fair value regulations—ASC 820 and IFRS 13—are primarily rules-based and provide technical advice about how investment firms should determine fair value. They define what fair value is and lay out a detailed framework covering, for example, the most advantageous market a security would trade in and how firms can calculate an exit price based on what they would likely receive were they to sell a particular security in an orderly market. They also identify certain levels assigned to securities for valuation purposes—Level 1, Level 2 and Level 3, based on the availability of observable or market inputs—which go some way to determining how fair values can be extrapolated. “The new rule doesn’t provide a step-by-step guide about how firms establish a security’s price—it’s more of a compliance fair value framework to manage valuations that an investment firm needs to implement,” explains Joseph Hayek who’s responsible for compliance and controls for Refinitiv’s Evaluated Pricing Service globally. “This framework would complete the fair value body: ASC 820 and IFRS 13 focus on the details of determining a fair value price, while the new rule is more of a compliance framework to determine value in good faith—it’s principles based as opposed to prescriptive.”

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Hayek, who has presented a comment letter to the SEC on behalf of Refinitiv Evaluated Pricing Service, explains that the firm is now in the process of laying the evaluated pricing groundwork to ensure that it meets its obligations and its clients’ expectations. “This is a continued evolution of valuation practices. The last time the SEC addressed valuations in a rule was in 1970 and since then the marketplace has dramatically changed in terms of size, depth and complexity. With ASC 820 and IFRS 13 becoming the foundation and widely used for determining fair value, it was only logical the SEC proposed to modernize the fund valuation practices.” Hayek explains. “So they published a rule that is more principles-based that investment firms and their boards would need to implement in order to manage valuation risk. The key part of the rule puts the [investment manager’s] board of directors in the driver seat, and while the board can outsource the work to the investment advisor it’s still ultimately responsible.”

Due Diligence

In the past, it was the investment advisor that was primarily responsible for valuations, which would manage typically by way of a valuations group. The group priced the firm’s holdings, conducted testing, it had various controls in place and it performed due diligence on pricing services. When a significant valuation issue arose, it was managed at the investment advisor, and presented to board, and the board was generally happy with that arrangement. But rule 2a-5 changes all that, according to Hayek. Now, board members themselves are obliged to ensure that there is a thorough, low-risk valuations process in place, and they need to monitor its accuracy and effectiveness, irrespective of whether they do it personally as the board or whether they delegate that obligation to the investment advisor.

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“The board meetings must now involve detailed reporting on the firm’s pricing process—this is not just the pricing of securities but crucially the process itself—any changes to the pricing services the firm uses, and any significant valuations matter that might arise or has already occurred must be reported,” Hayek explains. “Furthermore, they can’t wait until the end of the quarter to report issues—if a material valuation matter occurs, it has to be reported within three business days and the board is obliged to meet in order to discuss it and determine the risk to its end-investors. Although the board has always had a fiduciary responsibility [to its investors], now they’ll need to be more proactive in addressing valuation matters. While many investment firms may have similar practices in place already, others do not and will require an increase in resources to meet their obligations. It’s a matter of having a consistency across the industry.”

In a Nutshell

Key highlights of rule 2a-5 include valuation risk, which is any risk that can materially impact the accuracy of investment managers’ valuations. This includes mis-valuations; the use of unobservable inputs when determining valuations; selecting, testing and applying pricing methodologies, their regular calibration (back-testing) and their appropriateness for specific asset classes; and the extent to which they are applied consistently when determining fair valuations. Another key valuation risk is the extent which investment managers rely on vendors and other third parties to price their securities and portfolios. This is the first time the SEC has covered pricing services in its valuation rules. Effectively, the Commission will require investment managers to establish a process to oversee and evaluate any third-party pricing services they use. This includes processes and ongoing monitoring of the service, the establishment of a method by which they can ‘challenge’ prices or analyze in detail—known colloquially as ‘deep dives’—they must review the quality and experience of the provider’s staff producing those valuations, and they possess the ability to drill down into the inputs and assumptions so that they are comfortable that they reflect fair value where there is no active market or observable trades. The final part of the new rule pertains to record-keeping where all the inputs that were included when determining fair value are archived for a minimum period of five years.

Implications

Whenever new regulations are introduced to any facet of the capital markets, they tend to have a knock-on effect on the entire eco-system surrounding that specific business process and not just the organizations for which the regulations were initially conceived. In this instance, the industry’s third-party pricing specialists will no doubt encounter increased levels of scrutiny when it comes to the veracity and transparency of the valuations they provide their clients, principally around less liquid securities that typically entail non-observable inputs. As previously mentioned, advisors will be required by their boards to produce quarterly written assessments detailing the adequacy of their fair value processes, which will typically include details on valuation risks, changes to pricing methodologies and any testing results they might have performed during the course of the last quarter, the
allocation and sustainability of resources around their valuation processes, and any changes to the way they oversee their various pricing services. “Currently, many firms already have a process in place by which they oversee pricing services, and this is where it impacts us,” Hayek explains. “In the past, if we had a price correction, that stayed at the level of the valuations group responsible for managing those issues and their valuation committees. But now, if there is a material correction, it goes to the [investment manager’s] board, and they’re going to be asking lots of questions.”

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Clearly, all the industry’s pricing service providers are in the same boat, although if anything, rule 2a-5 is likely to increase demand from the investment management community for high-quality, reliable, accurate and transparent valuations services. In other words, the new dispensation will lead to something of a flight to quality as managers seek to carry out their fiduciary responsibilities as best they can, while simultaneously minimizing the chances of individuals—including board members—falling foul of the SEC. “This means that it is going to require a lot more transparency and disclosure, so that every time we produce a price, we provide our clients with all the inputs and assumptions and any other detail that went into pricing that security,” Hayek says.

As a global operation, Refinitiv is well positioned for this. It has the ability to access substantial data sources on a global scale that’s used to price millions of securities in a consistent and well controlled environment, Hayek explains. “We also prioritize client service, enabling direct access to our team of evaluators and permitting clients to submit challenges through our price challenge and transparency portal on the Refinitiv® Datascope Select platform.

Summary

What is clear is that when rule 2a-5 is finally added to the regulatory landscape surrounding the valuations industry, its impact on two primary industry groups—investment managers (and their boards) and the third-party pricing/valuations providers catering to that market—will be marked. Is it a necessary change and is it for the good? On balance, it probably is, even though most regulations when they are initially introduced are met by those directly affected by them with a mix of frustration and resistance. But for end-investors—the constituent for which most regulatory overhauls are intended—it can only be a good thing.
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