StradleyRonon

Talking Investment Management: Looking Back and Forward at the SEC's Rule for Fair Value

March 12, 2023 | Podcast Transcript

[Listen to the full podcast recording]

David Grim (00:05):

Hi everyone. Welcome to another episode of our Stradley Talking Investment Management podcast. I'm Dave Grim, and I am very pleased to be joined by some very special guests today. Carolyn McPhillips is the president of the Mutual Fund Directors Forum. The Forum is an independent nonprofit organization that serves independent directors of mutual funds and other registered investment companies, and it seeks to enhance fund governance by building a strong community among the directors through educational and networking opportunities. We're really, really excited to have Carolyn here with us. And I am also really excited to have my colleague Jennifer Hillman here. She's a colleague of mine here at Stradley Ronon, and she's here with us. And the reason that we're all here together is to talk about some collaboration that we have been doing together. As I mentioned the forum's, one of the forum's missions is to provide educational opportunities for fund directors.

David Grim (01:09):

And the forum in Stradley Ronon is about to publish a paper on fund valuation, which is a critical issue in our industry today. We're going to spend about 15 minutes together today talking about a few things. One is the importance of valuation. Another is the how and the why. We did this paper. Then we're gonna spend a little bit of time on what directors are currently focused on with respect to valuation, and then we're gonna provide a sneak peek at what's in the paper. This is intended to be a preview of the release of the paper, and we're gonna have a webinar, which is currently scheduled for Tuesday, November 14, at two o'clock Eastern. That's where we're gonna provide a deeper dive on the paper, and we hope you listen to us today, and you'll watch us when we get to that in November. So without further ado, let's get to it. Welcome, Jen and Carolyn. It's great to have you. I think to get us started, Carolyn, I was hoping maybe you could just give us some of your thoughts on the importance of valuation, the paper, the timing of it all, and why we're here together today. So turn it over to you.

Carolyn McPhillips (02:26):

Well, thanks so much for having me here today and for Stradley's partnership in writing this important paper for fund directors. As you alluded to, valuation is really a critical area of importance in what fund directors do. I wanna start talking a little bit about why valuation is important to fund investors. Because that's really the board's focus, they're looking out for the investors and the mutual funds. So, proper valuation of securities is critical to fairness for fund shareholders. If fund shares are improperly valued, either buying or selling shareholders are going to benefit at the expense of the other group. In addition, valuation is a potential area of conflict with the advisor, as valuation is the basis for the calculation of a fund's performance as well as its fees. So, valuation has always been a critical area. You don't have to sell the fact to directors that they should be focused on valuation.

Carolyn McPhillips (03:17):

It is one of the few duties that is specifically imposed on fund boards by the 1940 Act. In addition, boards really do oversee funds today that are a lot different than funds of the 1940s, 1950s and sixties, and the complicated assets that funds hold now. And even though directors aren't involved in the day-to-day evaluation of securities, the board plays a critical role in the valuation process. We thought now is a great time to provide additional guidance. As I mentioned, the fund industry is getting a lot more complex, and that complexity really does require more focus for fund directors. Our current guidance on valuation, which the forum published, is from 2012. So even if nothing had changed, it was probably time for an update of that paper. And we're also about one year out from compliance with Rule Two A. five. So something did in fact change, and something pretty big.

Carolyn McPhillips (04:09):

The period has given boards enough time to get comfortable with compliance with the rule and allow us to gain some meaningful insights into the process. I think if we had done this a little bit earlier, we wouldn't have had so much experience to draw on from the fund boards that are actually doing this in their boardrooms. But I do expect that where we are today is going to continue to evolve. And I don't think if we do this podcast again next year that we're gonna be talking about the same things because boards are gonna continue to learn and evolve in their processes. The rule also makes clear that the valuation process is supposed to be an iterative one. And boards understand that instinctively, and they will continue to change their practices to meet the needs of their funds.

Carolyn McPhillips (04:52):

They understand the gravity of their role in valuation. I mean, this is a really critical area. As I mentioned, it's fundamental to fairness to the shareholders in the funds, and they play a critical role in investor protection. And even though boards don't need any additional motivation to take their valuation responsibilities seriously, they're getting it from the SEC. And this is a very active SEC that is skeptical of board effectiveness in general. And the skepticism, in my opinion, has led to examinations of how funds and boards are complying with a brand new rule almost immediately after its effectiveness. I think this attention is unfortunate because it really did take away some time that boards would've liked to have to sort of tweak their processes and to get comfortable with what they were doing under a rule that while covers a familiar area it does require changes to what they did prior to the adoption of the rule.

Carolyn McPhillips (05:48):

And I think you can look at the paper and see that boards have to establish the valuation process that works best for their particular funds. There's no one-size-fits-all in the valuation area, like many other areas. But I think valuation in particular, because fund assets and investments vary so widely from fund to fund, and the paper isn't designed to be a prescriptive process that, you know, boards you should be doing X, Y, and Z and your valuation process, or you're, you're not upholding your responsibilities in this area. But I do think if you look at the paper, it really is a testament to how seriously boards take their responsibilities and really just look at, see what they really are responsible for, which is a significant issue for fund shareholders. And I wanna contrast there, we have boards in registered funds, but the private funds do not have independent boards.

Carolyn McPhillips (06:38):

And I think if you look at some valuation cases in that area, there have been a number of cases involving valuation erroneous valuations that resulted in overcharging of fund investors. The cases in that area range from inadequate policies and procedures to an advisor overvaluing securities, despite knowledge of the contrary regarding the value. And I think these cases really do show the importance of mutual fund boards, which really are in this space to oversee the process and to help police those sorts of conflicts that might arise if there weren't a board to protect them.

David Grim (07:15):

Excellent. That's really good. Kara, thank you for sort of laying out why we're all here today. Right. And so our next section is gonna be, we're gonna talk a little bit about what boards, what they're worried about, what they're focused on in the boardroom. But, just before we do that, Jen, could we just spend a couple of minutes on the framework that new rule two A five lays out for boards before we jump into what they're doing with that new rule? So, Jen, take it away.

Jennifer Hillman (07:45):

Great, thanks, Dave. As Carolyn mentioned, directors bear the ultimate responsibility under Section 2A 41 of the 1940 Act to determine the fair value of portfolio investments. Rule two A five replaced a patchwork of SEC guidance, provided requirements for determining fair value, and addressed the board's role with respect to this process. Among other things, the rule allows boards to designate the day-to-day duties related to fair evaluation to the evaluation designee, who, in large part, must be the investment advisor. The investment advisor may seek assistance from third parties and fulfilling its duties, but may not delegate them away under the rule. Fair valuation includes certain elements, assessing and managing valuation risks, establishing and applying fair valuation methodologies, testing those methodologies and evaluating pricing services. There is also a requirement for the valuation designee to reasonably segregate fair valuation determinations from portfolio management. This designation, however, is subject to ongoing oversight by the directors of the valuation designee and its valuation process.

Jennifer Hillman (08:52):

This oversight is an iterative process, as Carolyn mentioned, requiring that boards remain vigilant to new issues and changing market dynamics that may create price uncertainty. To assist with this oversight, the rule requires the boards to receive certain quarterly, annual and prompt reports along with additional reporting that the board may request. The paper provides great examples of questions that the board may wish to ask and examples of reports that the board may find helpful. It's important for boards to have good communication with the valuation designee to design their oversight and reporting in a way that is most effective for the board and most protective of shareholders.

David Grim (09:31):

Excellent. The SEC rolled out a pretty complicated rule and guidance. And Jen, that was nicely done, summarizing it all in a couple of minutes. As we jump into our next topic, as I mentioned, our next topic that we wanna spend a little bit of time on here today is, so what have boards been talking about when it comes to valuation in the boardroom? Carolyn, do you wanna start on that with what you've been hearing from your director colleagues?

Carolyn McPhillips (10:02):

Yeah, I'd love to. We talked to a lot of boards, so we do get some insights into how they deal with new rules. And as you mentioned, Dave, rule two A five is really complicated, and I think it's interesting, and I do think it caught a lot of boards off guard because I think they were surprised at the amount of time it actually took them to get into compliance with this rule. I think when you see a rule in an area where you're intimately familiar, you've been doing valuation oversight for a long time. I think maybe it wasn't expected that the time required to get into compliance with this rule would be as significant as it actually was. The rule does have a real benefit because it's giving boards an opportunity to review their practices around valuation in general. I also think that the iterative process will be emphasized as the boards consistently review their processes.

Carolyn McPhillips (10:57):

So I think boards really do take seriously the responsibility and valuation, and how they have to consider the process. But I think it is also easy for boards to get comfortable with a process that has worked for a long time. And I think the rule did spur some changes that were to the benefit of funds, boards and their shareholders. I think the rule really did encourage boards to take a look at their current governance practices to consider how well they functioned as they oversee valuation in light of the rules' requirements. The rule gives a lot of flexibility to fund boards and explains how they will carry out those responsibilities. So we've seen a variety of practices from oversight from the full board to boards establishing valuation committees of the board, which was, I think, pretty unusual prior to the rule. But some boards had considered it necessary in light of their funds, investments in particular.

Carolyn McPhillips (11:50):

And I'd just like to say for boards considering a board valuation committee, that directors really do keep in mind that the committee should focus on the role of the director in valuation oversight and make sure they're not crossing that line into the role of the valuation designee. I think compliance with the rule also reminded boards that they're not on an island as they oversee valuation and that they do have a lot of resources at their disposal. And I think it's impossible to discuss a board's resources in virtually any context, including this one, without mentioning the CCO. The CCO is the one monitoring compliance with the valuation policies and procedures, and they can provide other valuable insights into the process that helps the board in their oversight responsibilities. And then, of course, you can't talk about compliance without talking about reporting. Jen mentioned that the rule does have specific reporting requirements, but directors do still have a lot of ability to tailor that reporting based on the investments in their funds and the particular circumstances that their board faces.

Carolyn McPhillips (12:50):

This is critical to really allow boards to engage in the type of active oversight that the rule envisions. And it's easy to be overwhelmed with data and the valuation process. I think, you know, you sometimes hear from directors who, you know, are just getting a barrage of, of data from, you know, price challenges to fair values that that aren't really helpful. And I think the rule did provide another opportunity for fund boards to figure out what they actually need to see in those reports to actually conduct reasonable oversight as opposed to just getting data that they can't really use because it's just, you know, reams of data. So I think that's some of the main things we're hearing, but I'm thinking that Dave, you and Jen are gonna be hearing different things in your role as counselors to funds and fund boards.

David Grim (13:38):

Yeah, I mean, I guess I would say, I mean, we hear a lot of the same things. I guess I would start with that, for sure. I think that one of the things that we often hear is a curiosity about what everybody else is doing, right? And so that's a benefit that we can provide, you know, seeing a bunch of different practices. But that's also one of the incredible values of this paper that we're about to publish, right, is 'cause that was a real focus of ours, is sharing with the industry the different kinds of practices, whether it be around questions that trustees could consider asking or reporting that, you know, different advisors providing to board, like all different kinds of topics there. It's a collection of practices that we're seeing that we think make a lot of sense.

David Grim (14:28):

And so that's what we have been trying to share in the boardroom, and that's what we're gonna be sharing in this paper. So I think that probably makes a good time to sort of jump into just a little bit of a preview of what's in the paper. Mm-Hmm. As I mentioned at the beginning, we're gonna have a rollout of the paper, and we hope everybody reads the paper, and then we're gonna have a webinar where we go through in, in, in much more detail about what's in there. But Carolyn, if you had to, in, you know, a few minutes, talk about sort of how you think about the paper, how would you do it?

Carolyn McPhillips (15:01):

Yeah, I mean, first of all, we're really excited to make this paper and the upcoming webinar available to fund directors. Dave, you mentioned the value in learning from what other people are doing, and I think that boards will really find that there is a lot of value in this paper for that reason. We think that many directors are still really considering whether they have the right process and whether they're going to continue to be able to meet this valuation challenge. And so I think the paper really will help. Jen mentioned the questions that are embedded throughout the paper earlier when she was talking about the rule. And I think that really will give directors a lot of food for thought. That's one thing to tell directors what a rule requires, which obviously is important, and they need to understand what a rule actually says, but really, what helps directors the most is how to understand and how to apply that rule when they're in their boardroom.

Carolyn McPhillips (15:53):

And that's what these questions will do for them. And so I think that's something that directors will find especially valuable in this paper. I think boards have always approached valuation from one of active oversight, but I think the emphasis in the release in this area has encouraged them to think about what that actually means and empower them to work more proactively with the advisor. I think the rule really does give boards a lot of power here, which is good for them. And so I think it will help them figure out what they actually need to get from the advisor to make sure that they can meet the standard envisioned by the rule, and they have this opportunity about how they're going to or organize themselves and whether it's the best process for their funds and their shareholders. And I think as we talk in the paper, there's a variety of ways to get to the end result of how you're going to structure your valuation process on any particular board.

Carolyn McPhillips (16:48):

And I think it will be enormously helpful for fund boards. And as you mentioned, Dave, you know, they know their own process as well, and they have you, their auditors, and some others who can provide insights into what others are doing. And I think this paper just extends that a little bit because it shows them in black and white what other people might be doing or something they may not have considered in their own process. The paper combines experiences of a great working group of people who are involved in all kinds of aspects of the valuation process. And I think because you have that different perspective, you have an approach that boards can take that will help them think about valuation a little bit differently than I think they would have if, for example, the working group had only consisted of directors or only consisted of lawyers.

Carolyn McPhillips (17:39):

I think this holistic approach really will add a lot of kernels of information that boards can then internalize and think, okay, I can make my process better if I think about these particular areas that we explore in the paper. In addition, I think it's interesting that the paper really spends some time talking about the valuation designee's responsibilities. Obviously, it's not the board's job to tell the advisor how it should be structuring its valuation process. That's not the goal of this section of the paper. But I do think it's helpful for fund boards to appreciate how the advisor has set up its process for valuation, because I think it will then allow directors to have the information that they need to think of questions that they can ask the advisor just to get comfortable that the valuation designee is really able to manage the valuation process in a way that is required for their funds, especially for those funds that have really complicated valuation issues or if the advisor is trying to enter into a new asset class that might have associated areas with valuation that are important to consider.

Carolyn McPhillips (18:48):

Finally, I just wanna mention that I think the paper has something for directors of all experience levels, for directors newer to fund boards. The paper's gonna be a great primer to walk you through the valuation process, but that doesn't mean that experienced directors are not gonna take something away from this paper as well. The rule does require directors to consider new areas and think about other areas in a new way. And I think because of that, I think it will be really eye-opening to experience directors who may be set in a particular valuation process given their time on a board to think about new questions to ask, or new areas to consider in a way that is really helpful to hone their valuation process on their fund boards. And I'm curious, Dave and Jennifer, since you also have sort of a different perspective, how and where you think the real takeaways for the fund directors are in this paper?

David Grim (19:41):

I think you put them well, Carolyn, and I think that I would say that valuation is important to every board, right? And every director and everybody comes at it with their own experiences and expertise. And, and, and this paper's intended to speak to all of that. You mentioned the collaboration that we have on our group, right? Like, you know, we have a CCO, we have auditors, we have lawyers, we have directors, of course, and, and you know, we have the terrific forum staff. So it's a lot of wonderful experiences, and we really think that collection of experiences is gonna speak well to all the boards. I, you know, the last thing that I would say is when people, in terms of what boards are, are worried about with respect to valuation, in addition to sort of implementing this rule, the compliance date for the rule went into effect last September.

David Grim (20:41):

The SEC started going out and examining certain folks in the industry, right? And that was kind of a wake-up call for people with examiners in people's shops already. And so I think that has been working its way right through those who are being examined and folks trying to learn lessons from those exams. And I think that, you know, we've already listed a bunch of reasons why this paper is important, but I think this is the last one that I would list, which is, I think what you can read it and it will help you prepare for that kind of exam if you ever get that kind of examination request. So hopefully we've given you a whole bunch of reasons as to why you should wanna read this paper when it comes out. And also, hopefully, you'll wanna watch us on our webinar, which is coming up in a couple of months. So we're gonna wrap it there. But just before I do, I want to thank Carolyn personally for inviting Stradley Ronon to be part of this project. It's been absolutely terrific. I wanna give a shout out to our whole forum working group that we had in developing this paper. Just a bunch of terrific folks and experts, and thanks to Carolyn Jen for being with me today on this podcast. So, I hope you enjoyed listening and that we will see you on Tuesday, November 14, at 2:00 p.m. for our webinar.

(22:05):

Thanks so much for tuning in to episode four of Stradley Ronon's Talking Investment Management podcast. For more than 95 years, Stradley Ronon's investment management practice has helped shape the investment management industry by assisting with the creation of innovative investment products and services from obtaining industry first exemptive and no action relief to assisting in the development of novel products, we have helped our clients become or remain industry leaders as the investment management industry and our clients have evolved. So, are we adding attorneys with experience in emerging areas such as next generation exchange traded products, commodity futures, trading, commission regulation, swaps, and other derivatives trading? Meet our team at stradley.com.

For more information, contact:

David W. Grim
Partner and Co-Chair,
Investment Management
202.507.5164
dgrim@stradley.com

Jennifer Hillman
Partner
215.564.8623
jhillman@stradley.com

