

SEC Adopts Modernized Framework for Fund Valuation Practices

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A version of this article was republished in the [Temple 10-Q](#), Temple's Business Law Magazine.

On December 3, the SEC unanimously adopted new Rule 2a-5 (the Rule) under the Investment Company Act of 1940, as amended (the 1940 Act) to update the existing valuation framework for registered investment companies and business development companies.^{[1] [2]} Rule 2a-5 continues the SEC's initiative to modernize various responsibilities of fund boards.

Rule 2a-5 and related requirements approved in conjunction with the Rule, such as new Rule 31a-4, contain several noteworthy changes from the Rule as proposed in April. The SEC received more than 60 comment letters to the proposal. The changes to the Rule as proposed, and other important aspects of the rulemaking, are discussed in further detail below.

Under Rule 2a-5, determining fair value in good faith with respect to a fund will require the following functions and elements: (1) the periodic assessment and management of material risks associated with the determination of the fair value of the fund's investments, including material conflicts of interest; (2) the establishment and application of fair value methodologies and the periodic review of the selected methodologies; (3) the testing of the appropriateness and accuracy of the fair value methodologies selected; and (4) the oversight and evaluation of pricing services, when used. These functions and elements were adopted largely as initially proposed, though the final Rule does not include the proposed provision that would have separately required a fund to adopt written policies and procedures reasonably designed to achieve compliance with the requirements of the Rule. The adopting release states that Rule 38a-1 requires the adoption and implementation of policies and procedures reasonably designed to prevent violations of Rules 2a-5 and 31a-4, and that a fund board must approve such policies and procedures irrespective of whether the policies and procedures are those of the fund or the fund's adviser.

Under the new Rule, a fund board may choose to determine fair value by applying the functions and elements set forth above, or it may choose to designate a "valuation designee" to perform such responsibilities, subject to board oversight as outlined below. If the board designates the performance of fair value determinations to a valuation designee of the adviser, the designee will be required to specify the titles of the individuals responsible for determining the fair value of the designated investments, including specifying the functions for which each is responsible.

When using a valuation designee, board oversight and reporting requirements will include both quarterly and

annual written reporting, and in certain instances, more immediate reporting.

- **Quarterly Reporting** would include any reports or materials requested by the board related to the fair value of designated investments or the valuation designee's process for fair valuing fund investments, as well as a summary or description of material fair value matters that occurred in the prior quarter, including material changes to the valuation risks, methodologies, and process for selecting and overseeing pricing services during the quarter.
- **Annual Reporting** would include an assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of the designated portfolio of investments that includes, at a minimum, a summary of the results of the testing of fair value methodologies required and an assessment of the adequacy of resources allocated to the process for determining the fair value of designated investments, including any material changes to the roles or functions of the persons responsible for determining fair value.
- **More Immediate Reporting** involves prompt board notification, and board reporting would be required within five business days for matters that materially affect the fair value of the designated portfolio of investments. Material matters may include a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process or of material errors in the calculation of net asset value.

The final Rule provides that the board may “designate” the performance of these fair value determinations to a valuation designee. The use of this term is a change from the rule proposal that would have allowed the board to “assign” the role to an adviser, and serves to clarify the role of the board's oversight if it elects to use a designee. Additionally, while the final Rule largely declines to expand the range of permitted designees beyond the adviser, it allows for an officer of the fund to serve as a designee if the fund is internally managed. Finally, the final Rule's board reporting requirements were adjusted to be more flexible and less prescriptive than those initially proposed.

It seems likely that most fund boards will choose to use a valuation designee, and one issue registrants need to consider is the need for separate compensation arrangements for fund advisers because designated valuation services are typically excluded from the scope of services in existing advisory agreements.

In connection with the adoption of Rule 2a-5, the SEC also adopted new Rule 31a-4 under the 1940 Act, which will require funds or their advisers to maintain appropriate documentation to support fair value determinations and, where applicable, documentation related to the designation of the valuation designee. The substance of new Rule 31a-4 was originally included in the language of Rule 2a-5 in the proposing release, but was separated in the adopting release to create greater consistency with other 1940 Act recordkeeping requirements.

As proposed, the final Rule defines a “readily available market quotation” for purposes of Section 2(a)(41) of the 1940 Act, as one that is “is readily available only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable.” With respect to interplay between the new definition and the requirements of Rule 17a-7, the SEC stated that, under the Rule 2a-5 definition of readily available market quotations, some securities may no longer be eligible for cross trades under Rule 17a-7. The final adopting release acknowledges that some funds enter into cross trades in reliance on certain SEC staff no-action letters. It states that the SEC is currently in the process of reviewing these no-action letters to determine whether these letters, or portions thereof, should be withdrawn. In addition, the SEC states that potential revisions to Rule 17a-7 may be forthcoming.

In connection with the adoption of Rule 2a-5, the SEC is rescinding the following releases, no-action letters and guidance:

- Accounting Series Releases 113 and 118, which provide guidance on, among other things, how to determine fair value for restricted securities, as well as on accounting and auditing matters;
- SEC staff letters related to the board's role in the fair value process and other matters covered by the proposed Rule;
- Valuation-related guidance in the SEC's 2014 Money Market Funds rule release;
- Any staff guidance that is inconsistent or conflicts with the requirements of the Rules, even if not specifically identified in the list contained in the adopting release.

A complete list of the letters being rescinded is contained on page 100 of the adopting release.

With respect to Unit Investment Trusts, which do not have a board or adviser, the final Rule provides that the trustee or depositor must perform the fair value functions and elements noted above.

Rules 2a-5 and 31a-4 will become effective 60 days after publication in the *Federal Register*, and they will have a compliance date 18 months following the effective date to provide sufficient time for funds and valuation designees to come into compliance with the Rules.

The SEC's final Rule is available at <https://www.sec.gov/rules/final/2020/ic-34128.pdf>.

[1] Rule 2a-5 was proposed on April 21, 2020, as described in our *Investment Management Update* article titled, "SEC Proposes to Modernize Framework for Fund Valuation Practices" (<https://www.troutman.com/insights/investment-management-update-september-2020.html>).

[2] While not controlling on unregistered funds such as hedge funds, the staff's perspectives on valuation matters may provide a useful framework for those fund sponsors that grapple with valuation issues in unregistered funds that are not subject to regulation under the 1940 Act per se.

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