

SEC Rulemaking: Good Faith Determinations of Fair Value Under the Investment Company Act

Authored by Stephanie Capistrone, Stephen Bier, Julien Bourgeois, David Harris, Mark Perlow, Aaron Withrow, Nicholas DiLorenzo and Marylyn Harrell

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The U.S. Securities and Exchange Commission on December 3, 2020 adopted a long-anticipated rule for the fair valuation of fund investments.¹ Rule 2a-5 under the Investment Company Act of 1940 (final rule or rule): defines “readily available market quotations” as used throughout the Investment Company Act; establishes requirements for determining fair value in good faith; addresses both the board’s and the “valuation designee’s” role and responsibilities relating to fair valuation; and more closely ties together the applicable legal and accounting guidance on valuation.

The concept of “fair value” is embedded in the Investment Company Act’s definition of the “value” of a fund’s assets: the value of securities for which market quotations are not readily available is defined as fair value as determined in good faith by the fund’s board of directors.² Recognizing the evolution of markets and fund investment practices since the SEC’s issuance of its most recent comprehensive treatment of fund valuation,³ as well as three significant regulatory developments since that time,⁴ the SEC sought in the final rule to modernize and formalize the framework for fair value determinations under the Investment Company Act. The more formal framework and governance structure under the rule contains notable similarities with other recent SEC rulemakings relating to liquidity, funds of funds and derivatives.

EXECUTIVE SUMMARY

Rule 2a-5 creates a fair value regime focused on process, testing and oversight. The final rule:

- Defines “readily available market quotations” for purposes of the Investment Company Act definition of “value,” which establishes the scope of Rule 2a-5’s requirements;

¹ See [Good Faith Determinations of Fair Value](#), Rel. No. IC-34128 (Dec. 3, 2020) (Release). Unless otherwise specified, the term “fund” as used herein refers to a registered investment company or business development company (BDC). See Rule 2a-5(e)(1).

² See Investment Company Act Section 2(a)(41)(A), (B); see also Release at 4-5 (“The Investment Company Act requires funds to value their portfolio investments using the market value of their portfolio securities when market quotations are ‘readily available,’ and, when a market quotation for a portfolio security is not readily available or if the investment is not a security, by using the investment’s fair value, as determined in good faith by the fund’s board.”). Investment Company Act Section 59 makes Section 2(a)(41) applicable to BDCs. Release at 7 n.12.

³ See [Good Faith Determinations of Fair Value](#), SEC Rel. No. IC-33845 (Apr. 21, 2020) (Proposing Release) at 8 (noting that the SEC “last comprehensively addressed valuation under the Investment Company Act in a pair of releases issued in 1969 and 1970, Accounting Series Release 113 (ASR 113) and Accounting Series Release 118 (ASR 118)”); see also Statement Regarding “Restricted Securities,” Accounting Series Release No. 113 (Oct. 21, 1969); Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118 (Dec. 23, 1970).

⁴ These developments were the: (i) enactment of the Sarbanes-Oxley Act of 2002, the adoption of certain rules mandated thereby, and the establishment by such act of the Public Company Accounting Oversight Board (PCAOB); (ii) adoption of Rule 38a-1 under the Investment Company Act and Rule 206(4)-6 under the Investment Advisers Act of 1940; and (iii) issuance and codification by the Financial Accounting Standards Board of Accounting Standards Codification Topic 820 (ASC Topic 820). Proposing Release at 10-14.

- Sets forth detailed requirements for determining fair value in good faith; and
- Provides that a fund board may designate a valuation designee to perform fair value determinations, subject to a number of conditions.

Rule 2a-5 provides that, for purposes of Section 2(a)(41) of the Investment Company Act, a market quotation 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. This definition will more closely align Investment Company Act valuation principles with U.S. generally accepted accounting principles (GAAP). Rule 2a-5 specifies that a quotation is not readily available if it is not reliable. The SEC stated that the “definition of readily available market quotations” under Rule 2a-5 “will apply in all contexts under the Investment Company Act and the rules thereunder, including [R]ule 17a-7,” which may have far-reaching ramifications.

Under Rule 2a-5, determining fair value in good faith involves satisfying four requirements:

- Periodically assessing material risks associated with determining fair value of fund investments (valuation risks), including material conflicts of interest, and managing identified valuation risks;
- Establishing and applying fair value methodologies, taking into account the fund’s valuation risks;
- Testing the appropriateness and accuracy of fair value methodologies selected, including identifying testing methods and minimum frequency for their use; and
- Overseeing pricing services, if used.

Rule 2a-5 states that a fund’s board must determine fair value in good faith by carrying out the required functions noted above. The rule, however, permits the board to designate the fund’s “valuation designee,” which the board would continue to oversee, to perform fair value determinations relating to any or all fund investments. “Valuation designee” is defined as the fund’s investment adviser (excluding sub-advisers) or, for internally managed funds, a fund officer or officers. A valuation designee would carry out those responsibilities subject to certain additional conditions:

- Quarterly reporting containing a summary or description of material fair value matters during the prior quarter, as well as other materials requested by the board related to the fair value of designated investments or the valuation designee’s process;
- Annual reporting that includes a written assessment of the adequacy and effectiveness of the valuation designee’s process for determining the fair value of portfolio investments;
- Prompt written reporting of matters associated with the fair value process that materially affect the fair value of portfolio investments; and
- Reasonable segregation of the fair value determination process from portfolio management.

The Release indicates that the rule “establishes a principles-based framework for boards to use in creating their own specific process for making fair value determinations, including through designating and appropriately overseeing a valuation designee to perform certain valuation tasks.”⁵

In the Release, the SEC articulated certain high-level expectations regarding board oversight where the board designates a valuation designee to perform fair value determinations: boards should be objective and approach this oversight with a skeptical view; effective oversight is not passive but rather involves continuous engagement; and boards should consider this oversight to be an iterative process of identifying issues and opportunities for improvement.

The SEC also adopted a new recordkeeping rule – Rule 31a-4 – that requires certain records relating to fair value determinations to be maintained and preserved. These recordkeeping requirements relate to documentation to support fair value determinations and, when the board designates a valuation designee, certain board reports and lists of investments or investment types designated to the valuation designee.

The final rule reflects some modifications in response to industry comments, particularly as related to the content of valuation policies and procedures and to board reporting. However, the SEC declined to reframe Rule 2a-5 as a safe harbor, as many commenters had recommended. In addition, the rule’s definition of “readily available market quotations” reflects a narrower definition than the one used in practice by many funds (particularly with respect to fixed income securities, where the use of “evaluated prices” based, to varying degrees, on market activity, is the norm for daily valuations). As such, the implementation of the rule could have significant consequences under other provisions of the Investment Company Act and rules thereunder that incorporate this concept, notably Rule 17a-7.

The requirements of proposed Rule 2a-5, together with certain related considerations, are discussed in more detail below.

BACKGROUND

Valuation represents a critical responsibility of a fund, as the proper valuation of a fund’s portfolio securities is necessary for the calculation of the fund’s current net asset value (NAV) per share. Because the Investment Company Act requires that open-end funds offer and redeem their securities at a price based on the fund’s current NAV,⁶ improperly determined valuations may cause adverse consequences (e.g., dilution of fund shares, creation of arbitrage opportunities, improper computation of asset-based fees). Proper valuation of portfolio securities allows all transacting fund shareholders to pay or receive a price that represents their proportionate share of the fund’s portfolio. The concept of valuation also is embedded in many other provisions of the Investment Company Act, such as the Section 18 limitations on leverage, Section 5 diversification requirements, and the industry concentration rules.

Section 2(a)(41) of the Investment Company Act and Rule 2a-4 require valuation of a portfolio security at its “current market value” if market quotations for the security are “readily available.” Portfolio securities for which market quotations are not readily available must be valued at fair value as determined in good faith by the board of directors.

⁵ Release at 11.

⁶ Rule 22c-1(a) under the Investment Company Act requires that an open-end fund generally must sell and redeem its shares at a price based on the fund’s current NAV as next computed after the receipt of a redemption, purchase or sale order.

To provide guidance as to this requirement, the SEC issued a pair of releases – ASR 113⁷ in 1969 and ASR 118⁸ in 1970 – that addressed a variety of topics related to the valuation of fund portfolio securities. Importantly, ASR 113 and ASR 118 acknowledged certain practical realities associated with the fair value process. First, the SEC acknowledged that “the board need not itself perform each of the specific tasks required to calculate fair value in order to satisfy” its Section 2(a)(41) obligation.⁹ However, the board must “choose the methods” for determining fair value and “continuously review[] the appropriateness of such methods.”¹⁰ Second, the SEC stated that “[n]o single standard for determining ‘fair value ... in good faith’ can be laid down, since fair value depends upon the circumstances of each individual case.”¹¹

Subsequent to the issuance of ASR 113 and ASR 118, the SEC and its staff provided further guidance on fund valuation matters, most notably in a pair of letters from the SEC staff to the Investment Company Institute in 1999¹² and 2001.¹³ Among other topics, the letters provide further guidance regarding a board’s “good faith” responsibilities, particularly in light of emergency or unusual situations, and discuss the requirement to monitor for significant events that could impact the valuation of a fund’s investments. The 2001 Letter indicates that a fund investing in a foreign security “must evaluate whether a significant event (*i.e.*, an event that will affect the value of a portfolio security) has occurred after the foreign exchange or market has closed, but before the fund’s NAV calculation.”¹⁴ If so, the security’s closing price is not a “readily available” market quotation, and the security must be fair valued.¹⁵

The Proposing Release noted that there have been a number of regulatory developments that “fundamentally altered”¹⁶ how funds and fund boards address fair valuation since ASR 113 and ASR 118 were issued. First, the Sarbanes-Oxley Act of 2002 and the adoption of rules mandated thereby resulted in the establishment of the PCAOB, which in turn “has the authority to establish or adopt, among other things, professional standards, including audit and

⁷ In relevant part, ASR 113: (i) provides conceptual definitions of the key terms “readily available market quotations” and “fair value”; (ii) rejects any determination of fair value by an “automatic formula”; and (iii) confirms that fund boards can approve a fair value methodology while delegating calculations to other “persons” acting pursuant to the board’s direction, as long as the board “continuously” reviews the method chosen. It also requires that a fund board consider all relevant factors, including the operations of the issuer, changes in general market conditions, and the extent to which the inherent value of the securities may have changed. Further, ASR 113 defines “restricted security” and “current sale,” and applies a current sale test to fair value restricted securities.

⁸ In relevant part, ASR 118 addresses the valuation of securities listed or traded on a national securities exchange and securities that are traded in the over-the-counter (OTC) market, including the use of the last quoted sale price, published closing bid and asked prices and broker quotes. Specifically, it states that value can be determined fairly in more than one way for unlisted securities traded regularly in the OTC market, because fair value depends on the facts and circumstances of each situation. It also interprets “fair value” to mean the amount that a fund might “reasonably expect to receive for [a] security upon [its] current sale.” The Financial Accounting Standards Board (FASB) has provided similar albeit more comprehensive guidance. According to FASB, fair value is “the price that would be received [for the security] ... in an orderly transaction between market participants at the measurement date.” ASC 820-10-20.

⁹ Proposing Release at 9.

¹⁰ *Id.*

¹¹ ASR 118.

¹² [Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC](#) (Dec. 8, 1999).

¹³ [Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC](#) (Apr. 30, 2001) (2001 Letter).

¹⁴ 2001 Letter.

¹⁵ *Id.* The 2001 Letter describes how short-term investors could seek to take advantage of funds that do not account for such significant events when calculating NAV (*i.e.*, time zone arbitrage). Subsequently, as part of form amendments adopted following the market timing scandals, the SEC adopted a requirement for funds to disclose the circumstances under which fair value pricing will be used and the effects of such use. See [Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings](#), SEC Rel. No. IC-26418 (Apr. 19, 2004).

¹⁶ See Proposing Release at 10.

quality controls standards, to be used by registered public accounting firms in the preparation and issuance of audit reports.”¹⁷

Second, in 2003, the SEC adopted rules requiring investment advisers and registered investment companies to adopt compliance programs,¹⁸ including policies and procedures with respect to fair valuation, and to designate a chief compliance officer (CCO) to administer them. Further, in 2006, FASB issued Statement of Financial Accounting Standards No. 157 (now codified as ASC Topic 820), which “defines the term ‘fair value’ for purposes of the accounting standards and establishes a framework for the recognition, measurement, and disclosure of fair value under” U.S. GAAP, as reflected in fund financial statements. In general, ASC Topic 820 requires consideration of the exit price, which is the price that would be received in a hypothetical transaction in an orderly market. ASC Topic 820 uses “fair value” “to refer generally to the value of an asset or liability, regardless of whether that value is based on readily available market quotations or on other inputs,”¹⁹ and identifies three levels of inputs for pricing securities.²⁰

The Proposing Release states that the SEC proposed Rule 2a-5 to “reflect the increased role [these] subsequent accounting and auditing developments play in setting fund fair value practices, as well as the growing complexity of valuation and the interplay of the compliance rule in facilitating board oversight of funds.”²¹

DISCUSSION OF RULE 2a-5

“Readily Available Market Quotations”

The Rule 2a-5 definition of “readily available market quotations” essentially mirrors the definition of “Level 1” inputs under ASC Topic 820.²² Rule 2a-5 provides that a market quotation is readily available for purposes of the Investment Company Act definition of “value” 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.²³ As a practical matter, this means that any portfolio security priced using inputs other than Level 1 inputs will be subject to the fair value requirements of Rule 2a-5.²⁴ For instance, most fixed income

¹⁷ *Id.* at 10-14.

¹⁸ See *supra* note 4.

¹⁹ Proposing Release at n.13.

²⁰ Under ASC 820, the preferred valuation is based on a “Level 1” input (“[q]uoted prices (unadjusted) in active markets for identical assets ... that the reporting entity can access at the measurement date”), unless there is a significant event between the market close and measurement date. “Level 2” inputs are observable inputs other than quoted prices included within Level 1 (including quoted prices for similar securities, interest rates, prepayment spreads, and credit risks). “Level 3” inputs are significant unobservable inputs (including a fund’s own assumptions used to determine the fair value of investments).

²¹ Proposing Release at 14.

²² As noted above, “Level 1” inputs under ASC Topic 820 are defined as “[q]uoted prices (unadjusted) in active markets for *identical* assets ... that the reporting entity can access at the measurement date.” Release at n.336 (quoting ASC Topic 820-10-20) (emphasis in Release). The SEC noted that, “[d]espite the respective references to ‘securities similar in all respects’ in the Commission’s prior guidance [in ASR 113] and ‘identical assets’ in ASC Topic 820, we view these respective definitions as being substantively the same.” In ASR 113, the SEC had interpreted “readily available market quotations” as meaning “reports of current public quotations for securities similar in all respects to the securities in question.” *Id.*

²³ Rule 2a-5(c). The SEC explained that “under U.S. GAAP there are circumstances where otherwise relevant observable inputs become unreliable. Consistent with this, we will generally presume that a quote would be unreliable under [R]ule 2a-5(c) where it would require adjustment under U.S. GAAP or where U.S. GAAP would require consideration of additional inputs in determining the value of the security.” Release at 92. Separately, the SEC clarified that the word “unadjusted” in the final rule’s definition “refers to adjustments in market prices made by the fund or valuation designee, not adjustments made by the exchange on which the security is listed.” Release at 91.

²⁴ See Release at 88-89 (“This definition is consistent with the definition of a [L]evel 1 input in the fair value hierarchy outlined in U.S. GAAP. Thus, under the final definition, a security will be considered to have readily available market quotations if its value is determined solely by reference to these [L]evel 1 inputs. Fair value, as defined in the [Investment Company] Act and further

securities – which often are priced using evaluated prices from pricing services – will be considered securities for which market quotations are not readily available, and thus subject to the final rule’s requirements for determining fair value in good faith.²⁵ Similarly, securities that trade on a non-U.S. exchange and are valued using application of fair value adjustment factors provided by a pricing service also appear to be subject to these requirements. “Indications of interest” and “accommodation quotes” will not constitute readily available market quotations under the final rule.²⁶

Impact on Cross Trades and Availability of Rule 17a-7

The final rule’s definition of “readily available market quotations,” by its terms, applies “[f]or purposes of Section 2(a)(41)” of the Investment Company Act. The SEC nevertheless stated that the “definition of readily available market quotations that we are adopting will apply in all contexts under the [Investment Company] Act and the rules thereunder, including [R]ule 17a-7.”²⁷ Thus, without discussion in the Proposing Release and without clear consideration of the economic impact,²⁸ the SEC by pronouncement effectively prohibited reliance on Rule 17a-7 for cross trades of any securities other than those priced using solely Level 1 inputs.

As noted above, under the final rule, most fixed income securities will be considered securities for which market quotations are not readily available. Therefore, the SEC’s pronouncement could preclude such fixed income securities from being cross traded under Rule 17a-7.²⁹ The SEC acknowledged this effect, stating that “certain securities that had been previously viewed as having readily available market quotations and being available to cross trade under [R]ule 17a-7 may not meet our new definition and thus would not be available for such trades.”³⁰

The SEC also recognized that many cross trades are undertaken in reliance on certain SEC staff no-action letters, but noted that the “staff is reviewing these letters to determine whether these letters, or portions thereof, should be

defined in [R]ule 2a-5, therefore must be used in all other circumstances. ... [W]e do not believe that securities valued with [L]evel 2 inputs are consistent with the definition of readily available market quotations.”).

²⁵ The SEC noted that “under the final rule, evaluated prices are not readily available market quotations, as they are not based upon unadjusted quoted prices from active markets for identical investments.” Release at 89; see also [Money Market Fund Reform: Amendments to Form PF](#), SEC Rel. No. IC-31166 (July 23, 2014) (2014 Money Market Fund Release) at 286. In the Proposing Release, the 2014 Money Market Fund Release and [Investment Company Liquidity Risk Management Programs](#), SEC Rel. No. IC-32315 (Oct. 13, 2016) (Liquidity Rule Adopting Release), the SEC had noted that evaluated prices, “by themselves,” are not readily available market quotations. Proposing Release at 59; 2014 Money Market Fund Release at 286; Liquidity Rule Adopting Release at 248 n.801.

²⁶ Release at 89; see also Liquidity Rule Adopting Release at 248 (“‘Indications of interest’ and ‘accommodation quotes,’ may not necessarily reflect the current market values of the securities and thus are not ‘market quotations’ or ‘market values’ for the purposes of [R]ule 17a-7”) and n.800 (“Some dealers may provide only ‘indications of interest,’ *i.e.*, non-firm expressions of interest to trade that do not constitute quotations or ‘accommodation quotes.’”).

The SEC stated further that investments “in a mutual fund or similar structure that has a readily determinable fair value per share that is determined and published and is the basis for current transactions, such as a daily NAV for mutual fund shares” are considered to have readily available market quotations under Rule 2a-5. However, “securities that are valued using NAV as a practical expedient, like certain private funds ... generally do not have readily available market quotations under the final definition.” Release at 90-91.

²⁷ Release at 93. Rule 17a-7 exempts certain cross trades from the affiliated transaction prohibitions of Section 17(a) of the Investment Company Act, but the exemption is only available for securities “for which market quotations are readily available.” See Rule 17a-7(a).

²⁸ See Release at 125 (“approximately 28% of funds reported relying on [Rule] 17a-7 for cross trades, *but we cannot determine to what extent reliance on [Rule] 17a-7 is limited to investments meeting the definition under the final rule of having readily available market quotations*”), 158 n.584 (same) (emphasis added).

²⁹ Today, funds commonly cross trade many fixed income securities pursuant to Rule 17a-7, relying on the pricing approach detailed in Rule 17a-7(b)(4). Under Rule 17a-7, cross trades must be “effected at the independent current market price of the security,” which is defined for certain securities as “the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry.” Rule 17a-7(b)(4).

³⁰ Release at 94.

withdrawn.”³¹ In addition, the SEC noted that its current rulemaking agenda includes consideration of potential updates to Rule 17a-7. These developments, which could have far-reaching implications for investment companies and the debt markets, should be considered closely.

Fair Value Determination

Rule 2a-5 seeks to establish a “minimum, consistent framework” and a “standard of baseline practices across funds” for determining the fair value of fund investments in good faith.³² Under Rule 2a-5, determining fair value in good faith requires:

- Periodically assessing material valuation risks, including material conflicts of interest, and managing identified valuation risks;
- Establishing and applying fair value methodologies, taking into account the fund's valuation risks;
- Testing the appropriateness and accuracy of fair value methodologies selected, including identifying testing methods and minimum frequency for their use; and
- Overseeing pricing services, if used.

These requirements are discussed in further detail below. The SEC noted that Rule 38a-1 under the Investment Company Act “by its terms will require the adoption and implementation of written policies and procedures reasonably designed to prevent violations of the requirements of” Rule 2a-5.³³ In addition, rather than requiring the maintenance of specific records as part of Rule 2a-5, the SEC opted instead to adopt a separate rule – Rule 31a-4 – to contain recordkeeping requirements associated with Rule 2a-5.³⁴

In response to concerns raised by commenters that a technical failure could result in a statutory violation, the SEC “underscore[d] that the objective of the final rule is to ensure that a fund’s assets are properly valued,” and stated that “[a] violation of the final rule does not necessarily mean that the actual values ascribed to particular fund investments were in fact inappropriate, or, for example, that the fund has violated [R]ule 22c-1.”³⁵ In addition, by moving the

³¹ As examples of such no-action letters, the SEC identified United Municipal Bond Fund, SEC Staff No-Action Letter (Jan. 27, 1995) and Federated Municipal Funds, SEC Staff No-Action Letter (Nov. 20, 2006). In each of these letters, no-action relief was sought in relation to cross trades pursuant to Rule 17a-7 involving certain municipal securities “for which market quotations are not readily available.”

³² Release at 7-8. This language echoes discussion in other recent rulemakings. See, e.g., [Use of Derivatives by Registered Investment Companies and Business Development Companies](#), SEC Rel. No. IC-34084 (Nov. 2, 2020) (Derivatives Rule Adopting Release) at 8 (noting that new Rule 18f-4 “was designed to provide an updated and more comprehensive approach to the regulation of funds’ use of derivatives ... by replacing [SEC] and staff guidance with a codified, consistent regulatory framework”).

³³ Release at 38. In contrast to the proposal, the final rule does not include its own, separate provision requiring funds to adopt written policies and procedures for compliance with the rule. The SEC noted that “the requirements of [R]ule 2a-5 and guidance in this [R]elease will supersede the [Rule 38a-1 adopting release’s] discussion of policies and procedures for the pricing of portfolio securities and fund shares,” and that fair value policies and procedures for compliance with Rule 2a-5 (as well as new Rule 31a-4, discussed below) “must be approved by the board pursuant to [R]ule 38a-1 and may not be considered material amendments to existing fair value policies and procedures.” *Id.* at 38-39.

³⁴ See the section below titled “Recordkeeping Requirements.”

³⁵ Release at 12; see also [Commissioner Hester M. Peirce, Statement on Good Faith Determinations of Fair Value under the Investment Company Act of 1940 Final Rule](#) (Dec. 3, 2020) (“The decision not to craft the rule as a non-exclusive safe harbor should not be read to mean that the purpose of this rule is to trip people up on technicalities; its objective is to ensure that funds’ assets are properly valued, not to create a basis for enforcement actions rooted in inconsequential departures from the rule’s requirements.”).

recordkeeping requirements to a separate rule, the SEC addressed concerns that a recordkeeping failure alone could be deemed a failure to determine fair value in good faith.

Condition 1: Periodic Assessment of Material Valuation Risks

Rule 2a-5's first requirement for determining fair value in good faith is conducting a periodic assessment of material valuation risks (including material conflicts of interest) and managing these risks. Except for material conflicts of interest,³⁶ the final rule does not specify particular valuation risks that must be assessed and managed. The final rule also does not specify how frequently valuation risks must be reassessed, but the SEC noted that periodic reassessments should consider "changes in fund investments, significant changes in a fund's investment strategy or policies, market events, and other relevant factors."³⁷ The SEC noted that types and sources of valuation risk are fact-dependent and may include, without limitation:

- Types of investments held or intended to be held³⁸ and their characteristics (e.g., size relative to market demand);³⁹
- Potential market or sector shocks or dislocations and other types of disruptions that may affect a valuation designee's or a third-party's ability to operate (e.g., significant changes in short-term volatility, liquidity, or trading volume; sudden increases in trading suspensions; and system failures or cyberattack);
- The extent to which unobservable inputs are used in a fair value methodology, especially where such inputs are provided by the valuation designee;
- The proportion of fund investments that are fair valued and their contribution to fund returns;
- Reliance on service providers with more limited experience in relevant asset classes, the use of fair value methodologies that rely on third party-provided inputs, and the extent to which service providers rely on other service providers; and
- The use of inappropriate fair value methodologies, or the inconsistent or incorrect application of such methodologies.⁴⁰

Condition 2: Establishment and Application of Fair Value Methodologies

Determining fair value in good faith under Rule 2a-5 also requires establishing and applying fair value methodologies, taking into account the fund's valuation risks, which involves:

³⁶ Among advisers' potential conflicts of interest, the Release lists incentives to: inflate asset values (or deflate liability values) resulting from asset-based management fees; smooth fund performance to lower the fund's perceived risk; and expend less effort than required. Release at 126-127.

³⁷ *Id.* at 14.

³⁸ The SEC noted that the risk assessment and management "should take into account those investments that the fund reasonably expects to purchase in the reasonably near term." Release at n.46.

³⁹ *Id.* at n.47.

⁴⁰ Release at 16-17. The SEC also noted that valuation risk includes risks associated with determining whether an investment must be fair valued. Release at n.33.

- Selecting and applying in a consistent manner appropriate methodologies⁴¹ for determining and calculating fair value, including specifying key inputs and assumptions specific to each asset class or portfolio holding, provided that a selected methodology may be changed if a different methodology is equally or more representative of the fair value of fund investments;⁴²
- Periodically reviewing the appropriateness and accuracy of the methodologies selected and making necessary changes or adjustments; and
- Monitoring for circumstances that may necessitate the use of fair value.

Selecting Appropriate Methodologies: Consistency with ASC Topic 820

In order for a fair value methodology to be appropriate under Rule 2a-5, it “must be consistent with those used to prepare the fund’s financial statements and thus [must] be consistent with the principles of the valuation approaches laid out in ASC Topic 820.”⁴³ While the approaches in ASC Topic 820 might not address all circumstances a fund faces, approaches inconsistent with ASC Topic 820’s principles “may result in a fund having a misleading or inaccurate fair value process.”⁴⁴

Consistent with ASR 118, the SEC stated its belief that “fair value depends on the facts and circumstance of each investment, including the relevant market and market participants” and that “no single methodology” exists for determining an investment’s fair value.⁴⁵ Accordingly, the SEC recognized that “there may be a range of appropriate values that could reasonably be considered to be fair value” for a particular investment.⁴⁶

The SEC noted that 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 measurement date under current market conditions.” The SEC also stated that funds “may not fair value portfolio securities at prices not achievable on a current basis on the belief that the fund would not currently need to sell those securities.”⁴⁷

Consistent Application of Methodologies

Rule 2a-5 permits a fair value methodology to be changed if a different method is equally or more representative of fair value. The requirement to apply fair value methodologies consistently “is not meant to limit a board or valuation designee ... from using an appropriate methodology to fair value an investment, even if other investments within the

⁴¹ The SEC noted that while ASC Topic 820 “refers to valuation approaches and valuation techniques,” many valuation techniques are in practice referred to as “methods.” Accordingly, the Release “uses the terms ‘technique’ and ‘method’ interchangeably” and similarly “uses the terms ‘methods’ and methodologies’ interchangeably.” Release at 18 n.50.

⁴² Unlike the proposed rule, the final rule does not require specifying which methodologies apply to new types of investments in which a fund intends to invest.

⁴³ Release at 21.

⁴⁴ *Id.* Provided that they are not inconsistent with the principles outlined in ASC Topic 820, supplemental methodologies for circumstances not expressly outlined in ASC Topic 820 may be appropriately applied. *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.* at 21-22.

⁴⁷ *Id.* at 22-23. The SEC “continue[s] to believe that fair value cannot be based on what a buyer might pay at some later time, such as when the market ultimately recognizes the security’s true value as currently perceived by the portfolio manager.” *Id.* at 22. Guidance in the 2014 Money Market Fund Release on valuing thinly traded securities is superseded by Rule 2a-5 and the SEC’s associated guidance. *Id.*; see 2014 Money Market Fund Release at 284-285.

same ‘asset class’ are fair valued using a different appropriate methodology.” Similarly, the requirement does not prevent changing a selected methodology under appropriate circumstances and is not meant to “lock in place a rigid pre-established methodology, but [rather] to address the risks associated with switching methodologies in order to achieve a specific outcome.”⁴⁸

Key Inputs and Assumptions

Under Rule 2a-5, selecting and consistently applying appropriate fair value methodologies includes specifying key inputs and assumptions specific to each asset class or portfolio holding. The SEC elaborated that this requirement would involve providing detail “on the specific qualitative and quantitative factors to be considered, the sources of the methodology’s inputs and assumptions, and a description of how the calculation is to be performed (which may, but need not necessarily, take the form of a formula).”⁴⁹ Notably, the SEC explained that merely stating that particular types of investments are valued using a particular method (such as stating that options are valued using a Black-Scholes model), without more, would be insufficient under Rule 2a-5.⁵⁰

Periodic Reviews and Changes or Adjustments

The SEC explained that the results of fair value method testing (discussed in more detail below), or changed circumstances specific to an investment, could result in a fund needing to adjust its fair value methodologies. The SEC cited ASC Topic 820’s “non-exhaustive list of events that may warrant a change or an adjustment to a valuation technique”: (i) new markets develop; (ii) new information becomes available; (iii) information previously used is no longer available; (iv) the valuation technique improves; and (v) market conditions change.⁵¹

Monitoring for Circumstances That May Necessitate Fair Valuation

As discussed above, under the Investment Company Act’s definition of “value,” fair valuation is required when market quotations are not readily available, and Rule 2a-5(c) provides that a market quotation 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. Rule 2a-5 requires monitoring for circumstances when a market quotation is not “readily available” according to this definition. For example, where a fund invests in securities trading in foreign markets, the SEC stated that the board or valuation designee generally should identify and monitor for events that may suggest that market quotations are not reliable.⁵²

⁴⁸ Release at 19-20.

⁴⁹ *Id.* at n.51.

⁵⁰ *Id.*

⁵¹ Release at n.73 and accompanying text. The reference to “changes” in the rule text (“...making any necessary changes or adjustments”) was added “to clarify that a necessary adjustment to the selected methodology under the final rule is not limited to modifying an existing methodology for a particular investment (for example, adjusting inputs), but also may include changing to a new methodology where appropriate.” *Id.* at 25.

⁵² Release at 25 (“[I]f a fund invests in securities that trade in foreign markets, the board or valuation designee, as applicable, generally should identify and monitor for the kinds of significant events that, if they occurred after the market closes in the relevant jurisdiction but before the fund prices its shares, would materially affect the value of the security and therefore may suggest that market quotations are not reliable.”). In contrast to the proposal, the final rule does not specifically require establishing criteria for determining when market quotations are no longer reliable. *See id.* at 26.

Condition 3: Testing of Fair Value Methodologies

Rule 2a-5's third requirement for determining fair value in good faith is testing the appropriateness and accuracy of the fair value methodologies that have been selected, including identifying the testing methods to be used and the minimum frequency with which such testing methods are to be used. This requirement is intended to support the requirement discussed above to periodically review the appropriateness and accuracy of selected fair value methodologies and make necessary adjustments.

Under the testing requirement, the specific tests and testing frequency are dependent upon the fund's circumstances and are to be determined by the board or valuation designee, as applicable. The SEC discussed two types of testing in the Release – “calibration” and “back-testing” – as “particularly useful testing methods to identify trends in certain circumstances, and potentially to assist in identifying issues with methodologies applied by fund service providers, including poor performance or potential conflicts of interest.”⁵³ However, neither these nor other specific types of testing are mandated under Rule 2a-5, and the “final rule provides flexibility to allow funds to use new, appropriate testing methods” as they are developed.⁵⁴

Condition 4: Pricing Service Oversight

Rule 2a-5's fourth requirement is overseeing pricing service providers, if used, including establishing the processes for: (i) approving, monitoring and evaluating each pricing service provider; and (ii) initiating price challenges as appropriate.⁵⁵ The SEC noted that Rule 2a-5 includes these pricing service oversight requirements “so that the board or valuation designee, as applicable, has a reasonable basis to use the pricing information it receives as an input in determining fair value in good faith.”⁵⁶

The SEC believes that, before deciding to use a pricing service, the board or valuation designee, as applicable, generally should consider factors such as:

- The pricing service's qualifications, experience and history;
- The valuation methods, inputs and assumptions the pricing service uses for different asset classes, and how changing market conditions affect them (if at all);⁵⁷
- The quality of the information provided by the pricing service, and the extent to which the pricing service determines pricing information as close as possible to the time the fund calculates its NAV;
- The pricing service's process for considering price challenges, including how information from a price challenge is incorporated into pricing information;

⁵³ Release at 29.

⁵⁴ *Id.*

⁵⁵ The SEC declined to adopt specific criteria for who may qualify as a pricing service, but noted that the SEC “refer[s] to pricing services as third parties that regularly provide funds with information on evaluated prices, matrix prices, price opinions, or similar pricing estimates or information to assist in determining the fair value of fund investments.” Further, the SEC expressed its belief that pricing services as defined in PCAOB standards would be pricing services under Rule 2a-5. *Id.* at 33-34.

⁵⁶ *Id.* at 31.

⁵⁷ The SEC noted that, in considering pricing services' valuation methods, inputs and assumptions, fair value policies and procedures generally should address whether pricing services are relying on inputs or assumptions provided by the valuation designee or its affiliates. Release at n.117.

- The pricing service's potential conflicts of interest and steps taken to mitigate them; and
- The pricing service's testing process.⁵⁸

Where the board or valuation designee does not have a good faith basis for believing that the pricing service's pricing methodologies produce prices that reflect fair value, the board or valuation designee, as applicable, should "generally consider the appropriateness of using pricing information provided by" such pricing service in determining fair value.⁵⁹ Rule 2a-5 does not contain a specific requirement to review the selection of pricing services periodically, but the SEC believes that "the board or the valuation designee should, as part of their annual review of the adequacy and effectiveness of the fair value process, consider the adequacy and effectiveness of the pricing services used."⁶⁰

Rule 2a-5 requires establishment of a process for initiating price challenges as appropriate, which process "generally should outline the circumstances under which a price challenge should be initiated."⁶¹

Board (and Valuation Designee) Responsibilities Concerning Fair Valuation

Rule 2a-5 expressly places fair value responsibilities on a fund's board, following the language of Section 2(a)(41) of the Investment Company Act, but permits the board to designate⁶² a valuation designee, which the board would continue to oversee, to perform fair value determinations relating to any or all fund investments. In the Release, the SEC articulated its high-level expectations regarding the nature, scope and tone of board oversight:

- "Boards should approach their oversight of fair value ... with a skeptical and objective view";
- "[E]ffective oversight cannot be a passive activity"; and
- "The board should view oversight as an iterative process and seek to identify potential issues and opportunities to improve the fund's fair value processes."⁶³

⁵⁸ *Id.* at 36. This guidance supersedes prior SEC guidance in the 2014 Money Market Fund Release regarding the use of pricing services, which the SEC is rescinding. Release at n.116 and accompanying text; see also 2014 Money Market Fund Release at 285-288 (section entitled "Use of Pricing Services"). Guidance in the 2014 Money Market Fund Release concerning amortized cost valuation remains valid.

⁵⁹ Release at 36-37.

⁶⁰ *Id.* at 34. Following the issuance of the Release, the SEC announced an enforcement settlement that fund boards and valuation designees may find instructive in considering pricing service oversight. See [In the Matter of ICE Data Pricing & Reference Data, LLC](#), SEC Rel. No. IA-5643 (Dec. 9, 2020) (ICE Data). In ICE Data, the SEC made a number of allegations concerning: the inputs a pricing service used for certain securities; the visibility the pricing service's clients had concerning those inputs; the pricing service's quality controls; the age of certain price data used by and provided to clients by the pricing service; and the pricing service's treatment of certain price challenges.

⁶¹ Release at 33. The SEC noted that the requirement in the final rule to establish the *process* for initiating price challenges is distinct from the proposed requirement to establish *criteria* for the circumstances under which price challenges would be initiated. The SEC acknowledged that "there can be a range of circumstances under which a price challenge may be warranted, some of which cannot be distilled into specific criteria in advance." *Id.* at 32. Additionally, if a valuation designee is designated, the valuation designee's process for initiating price challenges is required to be subject to appropriate board oversight. *Id.* at n.104.

⁶² The Release indicates that the use of the term "designate" rather than "assign" when describing the relationship between a board and valuation designee is intended to indicate that the "the valuation designee performs the fair value determinations for the fund on the board's behalf subject to appropriate oversight by the fund's board," and to clarify that the board has not "completely delegated the entire valuation function and related obligations." Release at 41.

⁶³ *Id.* at 56. The SEC declined to confirm that boards must exercise oversight of fair valuation "consistent solely with the business judgment rule," stating its belief that the guidance it is providing "should be more useful to directors than the more generalized

These statements reiterate views that the SEC expressed in the Proposing Release, even though the SEC received many comments that it did not accurately or appropriately reflect the board oversight process.⁶⁴ The SEC also places the identification, monitoring and management of the valuation designee's and other service providers' conflicts of interest at the center of the board's oversight role.

Reiterating guidance provided in the Proposing Release, the Release acknowledges that what would constitute effective oversight could vary (e.g., by investment, fund or complex) based on a number of factors. For example, the Release explains that the appropriate level of scrutiny could vary based on the relevant fund's "valuation risk, including the extent to which fair value of the fund's investments depend on subjective inputs."⁶⁵ Notably, the SEC explained that "[a]s the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, [the SEC] would expect that the board's level of scrutiny would increase correspondingly."⁶⁶

A valuation designee designated to perform fair value determinations by a fund's board would carry out those determinations in accordance with the requirements set forth above in the "Fair Value Determination" section and subject to the following additional conditions:

- *Periodic Reporting:*
 - Quarterly Reporting: At least quarterly, the valuation designee is required to provide, in writing: (i) 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; and (ii) a summary or description of material fair value matters that occurred during the prior quarter;
 - Annual Reporting: At least annually, the valuation designee is required to provide a written assessment of the adequacy and effectiveness of its process for determining the fair value of the designated portfolio investments;
- *Prompt Reporting:* The valuation designee is required to promptly (within a time period determined by the board and, in any case, no later than five business days after the valuation designee becomes aware of the material matter)⁶⁷ report to the board in writing on the occurrence of matters that materially affect the fair value of the designated portfolio of investments; and
- *Segregation of Valuation and Portfolio Management Functions:* The valuation designee is required to: (i) specify the titles of persons responsible for determining fair value (including specifying particular functions for which such persons are responsible); and (ii) reasonably segregate fair value determinations from portfolio

principles of the business judgment rule, as this new guidance specifically relates to directors' oversight responsibilities under [S]ection 2(a)(41) of the [Investment Company] Act and the final rule."

⁶⁴ Release at nn.194, 195, 197-201.

⁶⁵ *Id.* at 56.

⁶⁶ *Id.*

⁶⁷ Under Rule 2a-5, the term "material matter" includes a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process, or material errors in the calculation of NAV. The board also could request, and if so, the valuation designee would be required to provide, such additional timely follow-on reporting as the board may determine.

management, such that the portfolio manager(s) may not determine, or effectively determine by exerting substantial influence on, the fair values assigned to portfolio investments.

Each such condition is discussed in further detail below.

Board Oversight over Fair Value Determination Designations

As noted above, Section 2(a)(41)(B) of the Investment Company Act provides that when market quotations for an instrument are not readily available, the “value” of that instrument means the “fair value as determined in good faith by the board of directors.” As a result, the SEC previously has taken the position that a fund board may not delegate the *determination* of fair value, but may delegate the task of *calculating* fair values, provided that the board satisfies itself that the resulting fair valuations are fair. Fund groups have established a variety of practices that seek to strike an appropriate balance between (i) the particular responsibilities that are carried out by the adviser and other service providers and (ii) the specific actions that must be taken by the board. Rule 2a-5 does not change a fund board’s statutory obligation to “determine” in “good faith” fair value; however, the rule provides fund boards with specific alternative frameworks for satisfying their statutory obligation to determine fair value.⁶⁸

Board-Derived Fair Value Determinations

A fund’s board would be permitted to carry out directly its statutory obligation under Section 2(a)(41) by determining the fair value of the fund’s portfolio holdings. Under this approach, the board would be required to satisfy the fair value determination requirements set forth in the “Fair Value Determination” section above.

Consistent with the proposed rule, a fund’s board is defined as “either the fund’s entire board of directors or a designated committee of such board composed of a majority of directors who are not interested persons of the fund.”⁶⁹ In the event that a designated committee is responsible for fair value determinations, the Release explains that the relevant fund would not be required to adopt policies and procedures governing circumstances where action by the full board, rather than a committee, would be required. However, fund boards are not prohibited from adopting such policies and procedures.⁷⁰

As discussed below, the Release states that a fund’s board could continue to seek assistance from others – such as the fund’s investment adviser, pricing services, or others – in fulfilling its duties under Rule 2a-5. However, the Release explains that such assistance does not relieve the fund board of its obligations or responsibilities with respect to fair valuation.

Valuation Designee-Derived Fair Value Determinations

As an alternative, Rule 2a-5 allows a fund board to satisfy its statutory obligation with respect to fair value determinations by designating a “valuation designee,” which the board would continue to oversee, to perform fair value determinations relating to any or all fund investments.

⁶⁸ The rule does not require boards to ratify fair value determinations, receive certifications from the adviser, make particular findings, or obtain third-party reviews of valuation matters, as some commenters had suggested or on which they had sought clarification. The SEC noted that it determined not to adopt specific oversight requirements beyond those proposed, as such requirements “may be duplicative or involve burdens that are not justified by their potential benefits.” Release at 54-55.

⁶⁹ Rule 2a-5(e)(3).

⁷⁰ Release at 49.

Under Rule 2a-5, the valuation designee may be the fund's investment adviser (other than a sub-adviser) or an officer of an internally managed fund. The SEC expressly declined to allow a board to designate a valuation designee other than the fund's adviser or officers (in the case of an internally managed fund),⁷¹ because the SEC believes that "it is critical for the entity actually performing the fair value determinations to owe a fiduciary duty to the fund and be subject to *direct* board oversight whenever possible."⁷² In this regard, the SEC noted what it believes to be the importance of requiring a valuation designee to owe a fiduciary duty to the fund in seeking to ensure that the valuation designee "acts in the fund's best interest."⁷³ The Release also states that the valuation designee must be an "adviser of the fund" and not simply an SEC-registered investment adviser, a distinction intended to clarify that a pricing service that is registered as an investment adviser could not serve as a valuation designee.⁷⁴

If the fund board designates a valuation designee, then:

- The valuation designee would be required to determine fair valuations consistent with the requirements set forth under the "Fair Value Determination" section above; and
- The board's designation would be subject to the conditions outlined above related to: (i) periodic reporting (quarterly and annual); (ii) prompt reporting; and (iii) segregation of valuation and portfolio management functions.

Roles of the Board and the Valuation Designee

Notwithstanding the option to designate a valuation designee, the SEC expressly stated that such designation does not relieve the fund's board of its statutory and fiduciary responsibilities to the fund. The SEC further stated that fund boards should take care to: (i) monitor for potential conflicts of interest;⁷⁵ (ii) probe the appropriateness of the valuation designee's fair value processes;⁷⁶ and (iii) take care in considering the "type, content, and frequency of reports that they receive."⁷⁷ Similar to the adopting release for Rule 38a-1 under the Investment Company Act, the Release expressly states that a fund board "can reasonably rely on the information provided to it in summaries and other materials provided by the valuation designee and other service providers in conducting appropriate oversight," but the board must "request and review such information as may be necessary to be informed of the valuation

⁷¹ In declining to permit a sub-adviser to act as a valuation designee, the SEC explained that the potential benefits to permitting sub-advisers to serve as valuation designees were outweighed by the challenges it would create including, among other things, "complicated reconciliation and oversight issues for boards, advisers, and sub-advisers." *Id.* at 46.

⁷² *Id.* at 43. (emphasis added). Specifically, the Release states that the SEC "believe[s] that having fiduciary obligations to the fund will help ensure that the party performing fair value determinations acts in the fund's best interest and, as appropriate, eliminates, mitigates, or discloses conflict."

⁷³ *Id.* at 43-44. Notably, the SEC expressly stated that it does "not believe that it is appropriate to" require pricing services to act as fiduciaries. *Id.*

⁷⁴ *Id.* at 50. The SEC declined to permit registered investment advisers other than an "adviser to the fund" to serve as valuation designee, because such entities "may not have a comprehensive and direct knowledge of the fund, a direct relationship with the board, or the same fiduciary duties to the fund in other cases." *Id.*

⁷⁵ For example, the SEC explained that (i) an adviser may have "an incentive to improperly value fund assets in order to increase fees, improve or smooth reported returns, or comply with the fund's investment policies and restrictions" and (ii) other service providers may have the incentive, or otherwise be subject to pressures, to "provide pricing estimates that are favorable to the valuation designee." Release at 57, 153.

⁷⁶ This may include, among other things, periodically reviewing (i) the "financial resources, technology, staff, and expertise of the valuation designee," (ii) the "reasonableness of the valuation designee's reliance on other fund service providers," and (iii) the valuation designee's compliance capabilities. Release at 58.

⁷⁷ *Id.*

designee's process for determining the fair value of fund investments.⁷⁸ Importantly, the SEC noted that a fund board may not be deemed to satisfy its oversight duty if it becomes aware of a material matter but does not inquire about such matter and take reasonable steps to ensure it is addressed.⁷⁹

The SEC expressly declined to impose specific oversight requirements beyond those set forth in the proposal. Instead, the SEC stated that it believes the oversight requirements set forth in Rule 2a-5, coupled with a board's fiduciary duty, are "reasonably designed to establish a minimum set of requirements for addressing the conflict of interest and other concerns associated with permitting a valuation designee to make fair value determinations."⁸⁰

Guidance on Obtaining the Assistance of Others

In response to comments received on the proposal, the SEC confirmed that a fund board or valuation designee "may of course obtain assistance from others in fulfilling its duties" and provided guidance on the circumstances under which the board or valuation agent may obtain such assistance.⁸¹ As examples, the Release cites potential assistance from pricing services, fund administrators, sub-advisers, accountants and/or counsel in the form of "performing back-testing as specified by the [board or] valuation designee and performing calculations as required by the valuation method selected by the board or valuation designee."⁸² However, the Release notes that a board or valuation designee remains responsible for fair value determinations notwithstanding the input or assistance of such other parties, and that fair value determination responsibilities may not be designated or assigned to those parties.

The following provides an overview of each condition that must be met when a fund board designates a valuation designee to perform fair value determinations, as outlined above.

Condition to Valuation Designee Designation 1: Periodic Reporting

Under Rule 2a-5, any valuation designee is required to provide the board with certain periodic reporting on a quarterly and an annual basis.

The periodic board reporting condition and the prompt board reporting condition discussed below are each intended to provide a fund board with insights into the salient features of a valuation designee's fair value process. Rule 2a-5(b)(1) states that any board reporting is required to "include such information as may be reasonably necessary for the board to evaluate the matters covered in the report."⁸³ Although the SEC did not elaborate on what level of information would satisfy the "reasonably necessary" standard, it did suggest that the reports should provide a board with sufficient information to "determine whether to ask additional questions or request additional information, as

⁷⁸ *Id.*

⁷⁹ *Id.* at 53 (stating that "[w]e believe that boards are not providing appropriate oversight if they simply rely on information presented to them without actively probing it, asking questions, and seeking relevant information, particularly when there are red flags or other indications of problems.").

⁸⁰ Release at 55.

⁸¹ *Id.* at 51.

⁸² *Id.* at 51.

⁸³ *Id.* at 66.

appropriate.”⁸⁴ Ultimately, the SEC explained, the level of reporting is left to the discretion of the fund board and valuation designee.

Quarterly Reporting

At least quarterly, the valuation designee is required to provide, in writing: (i) 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;⁸⁵ and (ii) a summary or description of “material fair value matters” that occurred during the prior quarter.⁸⁶

Specifically, the summary of material fair value matters during the prior quarter must include, at a minimum, a summary or description of the following:

1. *Material Changes to Valuation Risks*: Each quarterly report must include a summary or description of any material changes in the assessment and management of valuation risks, including any material changes in conflicts of interest of the valuation designee and any other service provider. This represents a change from the proposed rule, which would have required periodic board reports to include a description of the investment adviser’s assessment and management of (rather than material changes to) material valuation risks. The SEC explained that the rule focuses on material changes in the assessment and management of valuation risks to avoid rote reporting, but suggested that fund boards periodically request a list of all material valuation risks faced by the fund.⁸⁷
2. *Material Changes and Deviations (Methodologies)*: Each quarterly report must include a summary or description of any material changes to or material deviations from established fair value methodologies.
3. *Pricing Services*: Each quarterly report must include a summary or description of any material changes to the valuation designee’s process for selecting and overseeing pricing services and related material events (e.g., changes in service providers used or price overrides).
4. *Other*: Each quarterly report would also include any other materials requested by the board.

The SEC did not define the term “material fair value matter” for purposes of the quarterly reporting requirement. However, it did state that material fair value matters would “generally be those matters about which the board would reasonably need to know in order to exercise appropriate oversight of the valuation designee’s fair value determination process.”⁸⁸ For example, a material fair value matter would include: (i) significant deficiencies or material weaknesses” (as defined for purposes of Regulation S-X) in internal controls over financial reporting related to fair value determinations that have been identified; (ii) items that “could have materially affected”⁸⁹ the fair value of

⁸⁴ *Id.* at 66. The Release also does not prescribe a particular format for periodic or prompt reports. Instead, it states that the content of such reports could “take the form of narrative summaries, graphical representations, statistical analyses, dashboards, or exceptions-based reporting, among other methods.” *Id.* at 67.

⁸⁵ The Release indicates that this requirement is intended to “empower boards to tailor periodic reporting to suit the needs of their fund.” *Id.* at 64.

⁸⁶ The Release notes that material fair value matters relating to annual reporting items that occurred during the prior quarter are required to be reported as part of the quarterly report. Release at n.239.

⁸⁷ *Id.* at n.240.

⁸⁸ *Id.* at 65.

⁸⁹ This term, which appeared in the proposed rule, was eliminated from the final rule text.

the fund's investments; (iii) a change to a pricing service affiliated with the valuation designee; (iv) material changes to or deviations from methodologies, including changes to critical inputs or assumptions; and (v) a pattern of price challenges or overrides that raises concerns with the overall valuation process.⁹⁰ Importantly, the Release indicates that this standard is intended to be "similar to" the material compliance matter standard found in Rule 38a-1.⁹¹

Annual Reporting

In addition to the foregoing quarterly reports, at least annually, the valuation designee is required to provide a written assessment of the adequacy and effectiveness of its process for determining the fair value of the designated portfolio investments. Specifically, this annual report must include, at a minimum, a summary of the following:⁹²

1. *Testing Results*: Each annual report must summarize (rather than describe all of) the results of any testing of fair value methodologies' accuracy and appropriateness under Rule 2a-5(a)(3).
2. *Resource Adequacy*: Each annual report must summarize the adequacy of resources allocated to the fair value process, including any material changes to the roles or functions of those responsible for that process under Rule 2a-5(b)(2).

The Release makes clear that the periodic reporting requirements and, in particular, the modifications made in the final rule, are intended to implement a "certain minimum level of reporting" that is "necessary in order for the designation process to be consistent with the Investment Company Act."⁹³ Specifically, the SEC expects that the final periodic reporting requirements will "allow reporting to address the specific circumstances of each fund," and associated reporting will "be tailored to address the fund's holdings, valuation methodologies, and inputs."⁹⁴ However, the Release reiterates that the SEC views the list of specific items included in the Proposing Release that a fund board may consider requesting, if relevant,⁹⁵ as being potentially helpful to some fund boards, but reconfirms that reporting on such topic is not required.

Condition to Valuation Designee Designation 2: Prompt Reporting

The Rule requires the valuation designee to promptly (within a time period determined by the board and, in any case, no later than five business days after the valuation designee becomes aware of the material matter) report to the board in writing on the occurrence of matters that materially affect the fair value of the designated portfolio of investments. This would include, among other matters, any significant deficiency or material weakness in the design or implementation of the valuation designee's fair value determination process or material errors in the net asset

⁹⁰ Release at 65-66.

⁹¹ *Id.* at n. 247.

⁹² The use of the term "summary" as applied to the summary of testing results and assessment of allocated resources is intentional. Specifically, as indicated in the Release, the SEC expects that these summaries would provide boards with sufficient information to be able to seek more information from the valuation designee, if necessary, to conduct appropriate oversight. Release at 65.

⁹³ *Id.* 63.

⁹⁴ *Id.*

⁹⁵ For example, the Proposing Release indicated that a board also may request: (i) summaries of adviser price challenges; (ii) calibration and back-testing data regarding directional closeness and accuracy of fair values and next actual market prices; (iii) information regarding stale priced securities; (iv) information regarding internal tolerance threshold breaches; (v) narrative summaries of pricing errors; (vi) reports on pricing vendor due diligence reviews; (vii) results of independent auditor assessments of the valuation process; (viii) information regarding trends in portfolio holdings subject to fair valuation; and (ix) reports on the securities for which fair valuations were determined based on broker-provided information. References to the term "adviser" would be interpreted to include any valuation designee.

value calculation process.⁹⁶ Importantly, the prompt reporting requirement *is not* limited to issues related to the valuation designee's process (as it would have been under the proposed rule); the valuation designee itself need not have identified the material matter (*i.e.*, the fund's auditor could identify such matter); and the level of detail required is as much information "as may be reasonably necessary for the board to evaluate the matter covered."⁹⁷ The board also could request, and if so, the valuation designee would be required to provide, such additional timely follow-on reporting as the board may determine. Overall, the Release indicates that the prompt reporting requirement is intended to ensure that the fund board is notified of issues requiring "its immediate attention in a timely manner" while allowing the board to seek follow up as appropriate.⁹⁸

The Release indicates that, after identifying a matter, a valuation designee "should promptly determine the materiality" thereof and notify the board within five business days of its determination that a matter is material.⁹⁹ In some cases, such as where the materiality of the matter is immediately apparent or definitively determined by a third party, the valuation designee would then be required to report on the material matter within five business days of identification. However, the Release states that a valuation designee may take up to 20 business days to determine the materiality of a matter, provided that if a materiality determination has not been made within 20 days, the prompt reporting requirement within five business days is automatically triggered. The SEC indicated that valuation designees should not use the 20-day period "as a matter of course," and that taking more than 20 days either to determine materiality or begin the five business day period would be inconsistent with the "promptness" required by the rule.¹⁰⁰

Condition to Valuation Designee Designation 3: Segregation of Valuation and Portfolio Management Processes

Rule 2a-5 requires a valuation designee to: (i) specify the titles of persons responsible for determining fair value (including specifying particular functions for which such persons are responsible); and (ii) reasonably segregate fair value determinations from portfolio management, such that the portfolio manager(s) may not determine, or effectively determine by exerting substantial influence on, the fair values assigned to portfolio investments. The Release states that this requirement is designed to "allow funds to structure their fair value determination process and portfolio management functions in ways that are tailored to each fund's facts and circumstances."¹⁰¹ Similar to the liquidity and derivative rules, the SEC acknowledged the "important perspective and insight regarding the value of fund holdings that portfolio management personnel can provide" and, accordingly, did not exclude portfolio management personnel from providing input into the fair value process.¹⁰² However, the Release states that "a fund should limit the extent of influence portfolio managers may have on administration of the fair value process," and "[i]f portfolio managers provide a significant amount of input on the fair value of an investment, the segregation process should be appropriately rigorous and robust to mitigate any potential conflicts of interest."¹⁰³

⁹⁶ The SEC expressly declined to define the term "material error in the calculation of net asset value" but agreed that relying on a standard of \$0.01 a share or 0.5% of net asset value "would not be unreasonable." Release at 72.

⁹⁷ *Id.* at 69.

⁹⁸ *Id.*

⁹⁹ *Id.* at 73.

¹⁰⁰ *Id.* at 74 and n.278-279.

¹⁰¹ *Id.* at 79.

¹⁰² *Id.*

¹⁰³ *Id.* at 80.

Addressing the requirement to specify the titles of persons responsible for fair value determinations, the Release explains that a valuation designee would comply with this requirement if the fund's Rule 38a-1 fair value policies and procedures specify both the titles of the persons responsible for determining fair value and the roles and responsibilities of each person/title. As part of this requirement, the policies and procedures should specify both the valuation designee personnel responsible for price challenges and price overrides, as well as the roles and responsibilities of such persons. The Release also acknowledges that such determinations could be made by, or with input from, a valuation committee or similar body. Under these circumstances, the valuation designee would comply with this condition by describing the committee's composition and role, including through reference to the committee's governance documents, in the fund's Rule 38a-1 policies and procedures.

In explaining the requirement to segregate valuation and portfolio management functions, the Release states that portfolio managers should not be ultimately responsible for, or exert undue influence over, fair value determinations due to their potential conflicts of interest. However, the SEC acknowledged that despite the potential for conflicts of interest, portfolio managers can provide unique insights in the fair value determination process. Accordingly, the Rule requires "reasonable segregation of functions," and would allow funds to structure the fair value process in light of the fund's facts and circumstances, including the "size and resources" of the particular fund. Depending on the level of portfolio manager input, the segregation process should be appropriately tailored to mitigate against potential conflicts of interest. The Release indicates that reasonable segregation could be achieved through a variety of means including, among others, "independent reporting chains, oversight arrangements, or separate monitoring systems and personnel."¹⁰⁴ However, a "firewall" on communications between portfolio management and valuation personnel expressly would not be required. This approach to the incorporation of insights from portfolio management personnel echoes discussion in the liquidity rule and derivatives rule adopting releases, which in relevant part, also acknowledge the insights that portfolio management personnel can provide with respect to associated matters.¹⁰⁵

Recordkeeping Requirements

Appropriate Documentation to Support Fair Value Determinations

Rule 31a-4 requires maintenance of appropriate documentation to support fair value determinations made pursuant to Rule 2a-5.¹⁰⁶ This should include "documentation that would be sufficient for a third party, such as the Commission's staff, not involved in the preparation of the fair value determinations to verify, but not fully recreate, the fair value determination."¹⁰⁷ The SEC noted further that records that valuation designees currently create in the ordinary course of performing fair value duties, which may include "working papers supporting fair value determinations that include, for example, copies of internally developed valuation models, including inputs and assumptions used therein and relevant supporting documentation," are examples of "appropriate documentation to support fair value determinations."¹⁰⁸

¹⁰⁴ *Id.* at 79.

¹⁰⁵ Derivatives Rule Adopting Release at 55 ("We recognize the important perspective and insight regarding the fund's use of derivatives that the portfolio manager can provide and generally understand that the fund's derivatives risk manager would work with the fund's portfolio management in implementing the program requirement."); Liquidity Rule Adopting Release at 252 ("We agree that portfolio management provides valuable input into the liquidity risk management process.").

¹⁰⁶ See Rule 31a-4(a). This requirement replaces the proposed requirement to maintain records of the specific methodologies applied and assumptions and inputs forming the basis of the fair value determination in all cases. See Release at 81.

¹⁰⁷ Release at 84.

¹⁰⁸ *Id.*

The SEC noted that “appropriate documentation to support a fair value determination that takes into account inputs from pricing services consists of the records related to the fund or valuation designee’s initial due diligence investigation prior to selecting a pricing service and records from its ongoing monitoring and oversight of the pricing services.”¹⁰⁹ Other appropriate documentation includes the valuation designee’s work papers created while overseeing pricing services and testing fair value methodologies.¹¹⁰

Further, the SEC indicated that what constitutes appropriate records may vary depending on the security or fair value methodology used. For instance, documentation supporting fair valuation of a security valued using Level 3 inputs generally would be expected to involve different and “more extensive” documentation than an investment valued using only Level 2 inputs.¹¹¹

Records when Designating

In addition to appropriate documentation to support fair value determinations made pursuant to Rule 2a-5, when a valuation designee has been designated to perform fair value determinations, Rule 31a-4 requires maintenance of:

- Copies of the periodic and prompt reports and other information provided to the fund board under Rule 2a-5(b); and
- A list of investments or investment types whose fair value determinations have been designated to the valuation designee pursuant to Rule 2a-5.

Party to Maintain Records

Although each of the operative provisions of Rule 31a-4 refers to the registered investment company maintaining the covered records, Rule 31a-4(c) provides that if the board has designated the fund’s investment adviser to perform fair value functions, the adviser is to maintain the records required under Rule 31a-4. Otherwise, the fund is required to maintain such records.

Retention Periods

- *Appropriate documentation to support fair value determinations:* at least six years from the time that the determination was made, the first two years in an easily accessible place.
- *Copies of the periodic and prompt reports and other information provided to the fund board:* at least six years after the end of the fiscal year in which the documents were provided to the board, the first two years in an easily accessible place.
- *List of investments or investment types whose fair value determinations have been designated to the valuation designee:* a period beginning with the designation and ending at least six years after the end of the fiscal year in which the designation was terminated, in an easily accessible place until two years after such termination.

¹⁰⁹ *Id.* at 84; see also “Fair Value Determination – Condition 4: Pricing Service Oversight, *supra*. The final rule does not include a specific requirement for maintenance of “detailed records relating to the specific methodologies a pricing service applied and the assumptions and inputs a pricing service considered when providing each piece of pricing information.” Release at 84.

¹¹⁰ Release at 85.

¹¹¹ *Id.* The SEC stated that a variety of factors, including the subjectivity of fair value inputs, may influence the records kept.

Rescission of Prior Commission Releases, Existing SEC Staff No-Action Letters and Other Guidance

As discussed earlier, the SEC is rescinding ASR 113 and ASR 118 following the transition period noted below. The SEC disagreed with commenters who suggested that certain issues addressed in ASR 113 and ASR 118 are not covered by Rule 2a-5 and relevant accounting guidance, explaining that ASC Topic 820 sets forth “a principles-based framework for valuing all investments,” and retention of the incremental guidance contained in ASR 113 and ASR 118 therefore is not necessary.¹¹²

Additionally, the SEC noted that certain prior SEC guidance regarding pricing service oversight¹¹³ has been superseded by guidance in the Release and that, as noted above, prior guidance in the 2014 Money Market Fund Release regarding valuation of thinly traded securities is being rescinded and restated. The SEC further provided a list of SEC guidance, staff letters and staff guidance being withdrawn, noting that “[t]o the extent any staff guidance is inconsistent or conflicts with the requirements of the rules, even if not specifically identified [in the Release’s list], that guidance is superseded.”¹¹⁴

Further, as noted above, the SEC indicated that its staff is reviewing certain letters relating to Rule 17a-7 transactions, to determine whether such letters also should be withdrawn in whole or in part.

Key Dates and Timing

The SEC adopted an 18-month transition period for Rule 2a-5 and Rule 31a-4, commencing with the rules’ effective date.¹¹⁵ Rule 2a-5 and Rule 31a-4 will become effective 60 days after publication in the Federal Register, which had not occurred as of the date of this *OnPoint*.

¹¹² Release at 96-97.

¹¹³ See 2014 Money Market Fund Release.

¹¹⁴ Release at 99-100.

¹¹⁵ It is currently understood that the “readily available market quotations” definition does not apply with respect to Rule 17a-7 until the end of the 18-month transition period or such earlier time as a fund begins complying with Rule 2a-5.

This update was authored by:



[Stephanie Capistrone](#)

Partner
Boston
+1 617 728 7127
stephanie.capistrone@dechert.com



[Stephen H. Bier](#)

Partner
New York
+1 212 698 3889
stephen.bier@dechert.com



[Julien Bourgeois](#)

Partner
Washington, D.C.
+1 202 261 3451
julien.bourgeois@dechert.com



[David J. Harris](#)

Partner
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com



[Mark D. Perlow](#)

Partner
San Francisco
+1 415 262 4530
mark.perlow@dechert.com



[Aaron Withrow](#)

Associate
Washington, D.C.
+1 202 261 3442
aaron.withrow@dechert.com



[Nicholas DiLorenzo](#)

Associate
Boston
+1 617 728 7171
nicholas.dilorenzo@dechert.com



[Marylyn Harrell](#)

Associate
Washington, D.C.
+1 202 261 3436
marylyn.harrell@dechert.com

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