

MEMO# 32965

December 4, 2020

SEC Adopts New Fair Value Rule for Funds

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TO: ICI Members
Investment Company Directors

Audit and Attest
Audit Committees
Compliance
Fund Accounting & Financial Reporting
Fund Governance

SUBJECTS: Intermediary Oversight
Investment Advisers
Operations
Recordkeeping
Risk Oversight
Valuation

RE: SEC Adopts New Fair Value Rule for Funds

On December 3, the SEC adopted new Rule 2a-5 under the Investment Company Act, which addresses the fair valuation responsibilities of funds and their boards and advisers.[\[1\]](#) The SEC also adopted Rule 31a-4, a companion recordkeeping rule. The final rules reflect the SEC's belief that "to determine the fair value of fund investments in good faith requires a certain minimum, consistent framework for fair value and standard of baseline practices across funds... ." [\[2\]](#)

The rules will become effective 60 days after publication in the *Federal Register*, followed by an 18-month compliance period.

I. Background

Section 2(a)(41) of the Investment Company Act requires funds to value their portfolio investments (i) using market value when market quotations for those investments are "readily available," and (ii) when a market quotation for a portfolio investment is not readily available, by using "fair value as determined in good faith by the board of directors." [\[3\]](#) These investment-specific valuations largely determine a fund's overall net asset value.

Prior to adopting these rules, the SEC last comprehensively addressed fund valuation in

1969 and 1970 releases, Accounting Series Release 113 (“ASR 113”) and Accounting Series Release 118 (“ASR 118”). The Adopting Release cites several relevant market and regulatory developments occurring since then, including: developments in the accounting and auditing literature; the growing complexity of valuation; intervening regulatory developments such as the development of ASC Topic 820 and the interplay of Rule 38a-1 in facilitating board oversight of funds and the valuation process; and funds’ greater variety of investments, and their different and more significant valuation challenges.

The Adopting Release follows the SEC’s April 2020 proposal.

II. Summary of Rule 2a-5

A. Scope of the Rule

Consistent with the proposal, Rule 2a-5 will apply to all registered investment companies and BDCs (“funds”). More specifically, the rule’s requirements apply to any portfolio investments that do not have “readily available market quotations.”[\[4\]](#)

ICI and others recommended that this rule be recast as a safe harbor,[\[5\]](#) i.e., a non-exclusive means of complying with statute’s fair value obligation. The SEC did not make this modification. However, the Adopting Release states, “While a board or adviser’s failure to comply with the final rule’s requirements may call into question the effectiveness of the fund’s fair value process and its compliance program, the Commission underscores that the objective of the final rule is to ensure that a fund’s assets are properly valued.”[\[6\]](#)

B. General Requirements

The rule requires the performance of certain functions for a fund to determine “fair value in good faith”[\[7\]](#) of its investments in accordance with Section 2(a)(41) of the Investment Company Act and Rule 2a-4, including:

- Periodically assessing and managing material risks associated with fair value determinations,[\[8\]](#) including material conflicts of interest;
- Establishing and applying fair value methodologies;[\[9\]](#)
- Testing[\[10\]](#) fair value methodologies; and
- Evaluating any pricing services used.[\[11\]](#)

Unlike the proposal, the final rule itself does not require the fund to adopt and implement written fair value policies and procedures. Rather, 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 the 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).

In another change from the proposal, the final rule does not have recordkeeping requirements—those appear in new Rule 31a-4, discussed below.

C. Additional Requirements that Apply Upon a Designation of Fair Value Responsibilities

The rule permits the fund’s board[\[12\]](#) to designate[\[13\]](#) the fair value determination relating to any or all fund investments to a “valuation designee.”[\[14\]](#) Either the board (if it does not make such a designation) or the valuation designee must carry out the functions specified

above.

This designation would be subject to board oversight of the designee.^[15] In a substantially revised (and less onerous) reporting framework,^[16] the final rule requires a designee to provide the fund board with:

- Quarterly reporting, generally related to material changes or developments affecting fair valuation;^[17]
- Annual reporting, generally related to an overall assessment of the fair value process;^[18] and
- Prompt reporting, under certain circumstances.^[19]

This section of the rule also requires the designee to specify the titles of the persons responsible for determining the fair value of the designated investments (including their functions), and reasonably segregate fair value determinations from the portfolio management of the fund.^[20]

D. Other Rule Provisions

Unlike the proposed rule, the final rule permits either a UIT's trustee or its depositor to determine fair value in accordance with the rule's provisions.^[21]

III. Summary of Rule 31a-4

This new rule contains the recordkeeping requirements associated with Rule 2a-5.^[22] It requires a fund to maintain "appropriate documentation to support fair value determinations"^[23] made pursuant to Rule 2a-5. If a fund board has designated performance of fair value determinations to a valuation designee, the fund must maintain copies of: (i) the reports and other information provided to the board; and (ii) a specified list of the investments or investment types whose fair value determination has been designated to the valuation designee. Finally, the rule specifies that if the fund board has designated performance of fair value determinations to its investment adviser, the adviser shall maintain the records required by this rule (otherwise, the fund maintains such records).

IV. Additional Guidance Related to "Readily Available Market Quotations"

The Adopting Release discusses the implications of Rule 2a-5's definition of "readily available market quotations" for Rule 17a-7,^[24] stating that this new definition "will apply in all contexts under the Investment Company Act and the rules thereunder, including rule 17a-7."^[25] Further, "certain securities that had been previously viewed as having readily available market quotations and being available to cross trade under rule 17a-7 may not meet our new definition and thus would not be available for such trades." It acknowledges that funds enter into cross trades in reliance on certain SEC staff no-action letters, and states that "[t]he staff is reviewing these letters to determine whether these letters, or portions thereof, should be withdrawn." However, the SEC also notes that potential revisions to Rule 17a-7 are on the SEC's rulemaking agenda and invites input from the public on this subject.

V. Rescission of Prior SEC and Staff Valuation Guidance

As proposed, the SEC is rescinding ASR 113 and 118 (which provide guidance on, among other things, the role of the fund board in fair value determinations as well as guidance on certain accounting and auditing matters).^[26] SEC staff letters related to the board's role in

the fair value process and other matters covered by the proposed rule also are being withdrawn or rescinded.^[27] In addition to the items identified in the proposing release, the Adopting Release states that certain valuation-related guidance in the 2014 Money Market Funds Adopting Release^[28] is superseded, namely the specified paragraph related to thinly-traded securities and the sub-section on the use of pricing services. This will happen as of the compliance date, specified below.

VI. Effective and Compliance Dates

Rules 2a-5 and 31a-4 will become effective 60 days after publication in the Federal Register, and 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. A fund may voluntarily comply with the rules after the effective date. However, if the fund does so, it may not also consider SEC and staff letters and other guidance that will be withdrawn or rescinded on the compliance date.

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endnotes

^[1] *Good Faith Determinations of Fair Value*, SEC Release No. IC-34128, Dec. 3, 2020 (“Adopting Release”), available at www.sec.gov/rules/final/2020/ic-34128.pdf.

^[2] Adopting Release at 7-8.

^[3] See *also* Rule 2a-4 under the Investment Company Act, which defines “current net asset value” for computing the current price of a redeemable security.

^[4] Rule 2a-5(c) states 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.” This definition is consistent with the definition of a level 1 input in the fair value hierarchy outlined in US GAAP.

^[5] ICI’s comment letter is available at www.sec.gov/comments/s7-07-20/s70720-7433367-220249.pdf.

^[6] Adopting Release at 12.

^[7] The Adopting Release states, “We continue to believe that for any particular investment, there may be a range of appropriate values that could reasonably be considered to be fair value, and whether a specific value should be considered fair value will depend on the facts and circumstances of the particular investment.” Adopting Release at 21-22.

^[8] See Adopting Release at 16-17 for examples of valuation risk. The rule does not specify

a frequency for re-assessments.

[9] This includes: (i) selecting and applying in a consistent manner an appropriate methodology or methodologies for determining the fair value of fund investments, provided that a selected methodology may be changed if a different methodology is equally or more representative of the fair value of fund investments, including specifying the key inputs and assumptions specific to each asset class or portfolio holding; (ii) periodically reviewing the appropriateness and accuracy of the methodologies selected and making any necessary changes or adjustments thereto; and (iii) monitoring for circumstances that may necessitate the use of fair value.

These provisions are similar to those in the proposed rule, differing in that the final rule: (i) provides that the selected methodologies for fund investments may be changed if different methodologies are equally or more representative of the fair value of the investments; and (ii) does not require specification of methodologies that will apply to new types of investments in which the fund intends to invest. The Adopting Release further clarifies that “this requirement is not meant to limit a board or valuation designee, as applicable, from using an appropriate methodology to fair value an investment, even if other investments within the same ‘asset class’ are fair valued using a different appropriate methodology.” Adopting Release at 19.

[10] This involves testing the appropriateness and accuracy of the selected fair value methodologies, and includes identifying the testing methods to be used and the minimum testing frequency. The Adopting Release states that “the specific tests to be performed and the frequency with which such tests should be performed are matters that depend on the circumstances of each fund and thus should be determined by the board or the valuation designee, as applicable.” Adopting Release at 28. Moreover, while the SEC believes calibration and back-testing should be used, the rule does not require them.

[11] This includes “establishing the process for approving, monitoring, and evaluating each pricing service provider and initiating price challenges as appropriate.” Consistent with a recommendation in ICI’s comment letter, the final rule does not require the establishment of “criteria” for conducting price challenges, only a “process” for doing so. See Adopting Release at 36-37 for guidance on due diligence and oversight of pricing services.

[12] “Board” is defined to mean 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.

[13] Whereas the proposed rule used the term “assign,” the final rule uses the term “designate.” The Adopting Release explains, “[W]e believe that a board ‘designating’ a valuation designee to perform fair value determinations better describes the relationship between the board and valuation designee under the final rule—that is, one where 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.” Adopting Release at 41.

[14] The rule defines “valuation designee” as “the investment adviser, other than a sub-adviser, of a fund or, if the fund does not have an investment adviser, an officer or officers of the fund.” The proposed rule would have allowed a sub-adviser to carry out these responsibilities. However, the Adopting Release states that “[t]o the extent that other parties provide services that are essential for fair value determinations, the board or valuation designee can seek their assistance...” Adopting Release at 44.

[\[15\]](#) See Adopting Release at 55-59 for guidance on board oversight.

[\[16\]](#) ICI recommended a predominantly annual reporting framework, with quarterly reporting of (i) material changes to valuation risks or adviser-applied fair value methodologies (or material deviations therefrom); and (ii) significant deficiencies or material weaknesses in the design or implementation of the adviser's fair value determination process.

[\[17\]](#) Specifically, this requires at least quarterly reporting of: (i) any fair value reports or materials requested by the board; and (ii) a summary or description of material fair value matters that occurred in the prior quarter, including: (a) any material changes in the assessment and management of valuation risks; (b) any material changes to, or material deviations from, established fair value methodologies; and (c) any material changes to the valuation designee's process for selecting and overseeing pricing services, as well as any material events related to the valuation designee's oversight of pricing services.

[\[18\]](#) Specifically, this requires an annual assessment the adequacy and effectiveness of the valuation designee's process for determining the fair value of the designated portfolio of investments, including (i) a summary of the results of the testing of fair value methodologies; and (ii) 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.

[\[19\]](#) Specifically, this requires the valuation designee to notify the board of the occurrence of "matters that materially affect the fair value of the designated portfolio of investments, including 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 net asset value, (any such matter or error, a 'material matter') within a time period determined by the board (but in no event later than five business days after the valuation designee becomes aware of the material matter), with such timely follow-on reporting as the board may determine appropriate." This requirement is considerably less expansive than that in the proposed rule. Moreover, the Adopting Release recognizes that determining the materiality of a matter may take time, and suggests 20 business days as an outer limit on this determination timeframe. See Adopting Release at 73-74.

[\[20\]](#) The Adopting Release notes that "[r]easonable segregation of functions facilitates these important checks and balances, and funds could institute this requirement through a variety of methods, such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel." Adopting Release at 79.

[\[21\]](#) ICI's comment letter recommended an expansion of entities permitted to carry out these functions for UITs. Also, existing UITs are being grandfathered, such that if the initial deposit of portfolio securities into the UIT occurred before the rule's effective date, and an entity other than the fund's trustee or depositor has been designated to carry out the fair value determination, that entity must carry out the requirements of paragraph (a) of the rule.

[\[22\]](#) These recordkeeping obligations are substantially less burdensome than those in the proposed rule, and reducing those burdens was a point of emphasis in ICI's comment letter (the proposed rule would have required recordkeeping of "information regarding the specific methodologies applied and the assumptions and inputs considered when making fair value determinations").

[23] The Adopting Release clarifies 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. ... Other appropriate documentation also includes work papers created by the valuation designee while overseeing pricing services or testing fair value methodologies, such as those documenting the valuation designee’s monitoring and conducting of price challenges, stale price analysis, and testing such as calibration or back-testing.” Adopting Release at 84-85.

[24] Funds may enter into a cross trade in reliance on Rule 17a-7 only if the “transaction is a purchase or sale... of a security for which market quotations are readily available.”

[25] Adopting Release at 93.

[26] The rescission will eliminate the requirement for the independent accountant to verify all quotations of securities with readily available market quotations at the balance sheet date. Independent accountants will continue to be required to verify the ownership of securities under Section 30(g) of the Investment Company Act.

[27] See Adopting Release at 100 for a list of these staff letters and Commission and staff guidance. Moreover, the Adopting Release states, “To the extent any staff guidance is inconsistent or conflicts with the requirements of the rules, even if not specifically identified below, that guidance is superseded.”

[28] *Money Market Fund Reform; Amendments to Form PF*, SEC Release No. 33-9616 (July 23, 2014) available at www.sec.gov/rules/final/2014/33-9616.pdf.