

MEMO# 32409

April 23, 2020

SEC Proposes New Rule on Fair Valuation for Funds

[32409]

April 23, 2020 TO: ICI Members
Investment Company Directors SUBJECTS: Audit and Attest
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Valuation RE: SEC Proposes New Rule on Fair Valuation for Funds

On April 21, the SEC proposed new Rule 2a-5 under the Investment Company Act, which would address the fair valuation responsibilities of a fund's board and its adviser(s).[\[1\]](#) Comments are due by July 21.

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."[\[2\]](#) These investment-specific valuations largely determine a fund's overall net asset value.

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 Proposing Release cites several relevant market and regulatory developments occurring since then, including:

- Funds' greater variety of investments, and their different and more significant valuation challenges;
- Greater volume of available data related to valuation and new technologies that

- facilitate enhanced price discovery and greater transparency;
- Use of third-party pricing services;
- Enactment of the Sarbanes-Oxley Act of 2002 and adoption of related rules;
- Adoption of compliance rules under the Investment Company Act and Investment Advisers Act in 2003; and
- Issuance and codification by the Financial Accounting Standards Board (“FASB”) of ASC Topic 820 in 2006 and 2009.

The Proposing Release notes that “fair value often requires greater resources and expertise than when the Commission issued ASR 113 and ASR 118 roughly fifty years ago ... [and] regulatory changes during that period have altered the way that boards, fund investment advisers, other fund service providers, and auditors address valuation.”[\[3\]](#)

Summary of Proposed Rule

Proposed Rule 2a-5 would apply to all registered investment companies and BDCs (“funds”). It would require the performance of certain functions for a fund to determine the “fair value in good faith”[\[4\]](#) 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,[\[5\]](#) including material conflicts of interest;
- Establishing,[\[6\]](#) applying, and testing[\[7\]](#) fair value methodologies;
- Overseeing and evaluating any pricing services used;[\[8\]](#)
- Adopting and implementing written fair value policies and procedures that are reasonably designed to achieve compliance with the aforementioned rule requirements;[\[9\]](#) and
- Satisfying recordkeeping requirements.[\[10\]](#)

Significantly, the proposed rule would permit the fund’s board[\[11\]](#) to assign the fair value determination relating to any or all fund investments to an investment adviser[\[12\]](#) of the fund, which would carry out the functions specified above.[\[13\]](#) The proposed rule is “designed to provide boards and advisers with a consistent, modern approach to the allocation of fair value functions, while also preserving a crucial role for boards to fulfill their obligations under section 2(a)(41) of the Act.”[\[14\]](#)

This assignment would be subject to the following additional requirements:

- Board oversight of the adviser, including periodic[\[15\]](#) and prompt[\[16\]](#) reporting to the board addressing specified matters;
- Specification of responsibilities and reasonable segregation (from portfolio management)[\[17\]](#) of duties among the adviser’s personnel; and
- Recordkeeping relevant to the assignment.

Also, the proposed rule would:

- Specify 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”;[\[18\]](#) and
- Require a UIT’s trustee to determine fair value in accordance with the rule’s provisions.

Proposed Rescission of Prior SEC and Staff Valuation Guidance

If the rule is adopted, the SEC would rescind 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).^[19] The Proposing Release notes that because of developments in the FASB accounting standards, “fund-specific accounting guidance for recognition, measurement, and disclosure provided in those statements may no longer be necessary.”^[20] SEC staff letters related to the board’s role in the fair value process and other matters covered by the proposed rule also would be withdrawn.^[21]

Proposed Effective Date

The SEC proposes a one-year transition period (following publication of the final rule in the Federal Register) to provide time for funds and their advisers to come into compliance with any final rule. Rescissions of all relevant SEC and staff guidance also would occur at that time.

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endnotes

^[1] *Good Faith Determinations of Fair Value*, SEC Release No. IC-33845, Apr. 21, 2020 (“Proposing Release”), available at www.sec.gov/rules/proposed/2020/ic-33845.pdf.

^[2] 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.

^[3] Proposing Release at 13-14.

^[4] The Proposing 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.” Proposing Release at 22.

^[5] See Proposing Release at 17-18 for examples of valuation risk.

^[6] This would require specifying (i) the key inputs and assumptions specific to each asset class or portfolio holding; and (ii) which methodologies apply to new types of fund investments in which a fund intends to invest. It also would require (i) periodically reviewing the appropriateness and accuracy of the methodologies selected and making necessary adjustments; (ii) monitoring for circumstances that may necessitate the use of fair value; and (iii) establishing criteria for determining when market quotations are no longer reliable.

^[7] This would involve testing the appropriateness and accuracy of the selected fair value methodologies, and include identifying the testing methods to be used and the minimum testing frequency.

[8] This would include establishing (i) the process for the approval, monitoring, and evaluation of each pricing service provider; and (ii) criteria for initiating price challenges.

[9] The Proposing Release notes that Rule 38a-1 would apply to a fund's obligations under the proposed rule, and that "[t]o the extent that adviser policies and procedures under proposed rule 2a-5 would otherwise be duplicative of fund valuation policies under rule 38a-1, a fund could adopt the rule 2a-5 policies and procedures of the adviser in fulfilling its rule 38a-1 obligations." Proposing Release at 27.

[10] This would include maintaining appropriate documentation to support fair value determinations and a copy of policies and procedures.

[11] "Board" would be 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.

[12] The Proposing Release states, "A fund's board could make this assignment to a fund's primary adviser or one or more sub-advisers." Proposing Release at 33.

[13] Consistent with the statute, the fund's board also could perform these functions.

[14] Proposing Release at 32.

[15] This would require quarterly assessments of the adequacy and effectiveness of the adviser's fair value process, including a summary or description of: (i) assessment and management of material valuation risk; (ii) any material changes to, or material deviations from, established fair value methodologies; (iii) testing results; (iv) adequacy of resources allocated to the fair value process, including any material changes to the roles or functions of the responsible persons; (v) any material changes to the adviser's process for selecting and overseeing pricing services, as well as material events related to this oversight (such as changes in service providers or price overrides); and (vi) any other materials requested by the board.

[16] This would require prompt (i.e., no event later than three business days after the adviser becomes aware of the matter) reporting on matters associated with the adviser's process that materially affect or could have materially affected the fair value of the investments, including a significant deficiency or material weakness in the design or implementation of the adviser's fair value process or material changes in the fund's valuation risk.

[17] The Proposing Release states that "a fund generally should consider the extent of influence portfolio managers may have on administration of the fair value process, and seek to provide independent voices and administration of the process as a check on any potential conflicts of interest to the extent appropriate." Proposing Release at 54.

[18] Under Section 2(a)(41) of the Investment Company Act, if an investment does not have a "readily available market quotation," it must be fair valued. The Investment Company Act and rules thereunder presently do not define "readily available." This proposed approach is substantially similar to the description of a Level 1 input under the US GAAP fair value hierarchy.

[19] The rescission would eliminate the requirement for the independent accountant to verify all quotations of securities with readily available market quotations at the balance

sheet date.

[\[20\]](#) Proposing Release at 61.

[\[21\]](#) See Proposing Release at 66-67 for a list of these staff letters and guidance.

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