

Alert

Regulated Funds: SEC Adopts New Fair Valuation Framework

December 17, 2020

On Dec. 3, 2020, the SEC adopted a new rule under the Investment Company Act of 1940, as amended, (“1940 Act”) addressing the valuation practices of registered investment companies and business development companies (“funds”).¹ Rule 2a-5 (“Rule”) represents an effort to modernize and codify a principles-based framework for fair value determination of fund investments. Most significantly, in a departure from prior SEC guidance and interpretation, and subject to several requirements and the continued oversight of the board, the Rule allows a fund’s board to designate the fair value determination of the fund’s investments to the fund’s investment adviser, or, in the case of an internally managed fund, to an officer of the fund (each, a “valuation designee”), rather than requiring the board to make the final determination itself.²

The Rule, which was first proposed in April 2020,³ provides considerable benefit to funds that invest from time to time in illiquid securities that do not have readily available market quotations, particularly when such illiquid investments represent a relatively small percentage of a fund’s overall portfolio.⁴ With the assistance of investment advisers, boards of such funds are currently required to engage in a time-consuming and intensive process to make fair value determinations for these hard to value investments on a regular basis. Under the Rule, these boards will retain oversight of the valuation process, but can formally designate the fair value determination with respect to such illiquid assets, including the specific process for making fair value determinations, to a valuation designee.

Notably, a number of the requirements imposed under the Rule, including segregating the valuation process from the portfolio management function, may make reliance by funds that primarily invest in illiquid assets, such as business development companies (“BDCs”), less attractive. In particular, BDCs and other similar illiquid-focused funds tend to have well-developed procedures for boards to interact with both advisory personnel and third-party valuation firms, where appropriate, as part of the periodic valuation process. As a result, the boards of such funds may be less willing to delegate their responsibilities and therefore potentially reduce their visibility with respect to, and integral participation in, the valuation process. In addition, advisers to such funds may be less willing to segregate portfolio management personnel from the valuation process, as would be required under the Rule.

In contrast, open-end funds, including mutual funds and exchange-traded funds, may be more likely to take advantage of the flexibility afforded under the Rule. Specifically, such open-end funds would

¹ Good Faith Determinations of Fair Value, Investment Company Act Release No. 34128 (Dec. 3, 2020), available [here](#).

² In a change from the rule as proposed, a fund’s sub-adviser may not serve as a valuation designee.

³ Good Faith Determinations of Fair Value, Investment Company Act Release No. 33845 (April 21, 2020), available [here](#).

⁴ These investments typically are valued using inputs categorized within Level 3 of the fair value hierarchy established by the Financial Accounting Standards Board in ASC Topic 820.

normally only have a small percentage of their respective portfolios invested in illiquid investments, if any. The ability to adopt detailed procedures to permit an open-end fund's board to delegate the valuation of such illiquid investments to the fund's adviser would, therefore, allow such funds to more easily and efficiently handle assets that unexpectedly become illiquid, while also treating such investments in a manner that would be more consistent with how liquid investments are presently valued by most open-end funds. In addition, the delegation of fair value determinations provided under the Rule would ease the burden of setting an open-end fund's net asset value, and therefore the value of its investment portfolio, on a daily basis.

Although the Rule addresses funds regulated under the 1940 Act, the Rule and the release adopting the Rule ("Adopting Release") may also provide insight into certain valuation-related matters with respect to investment advisers that advise private funds, including relating to potential conflicts of interest in the valuation process. In addition, advisers that primarily advise private funds but also advise or sub-advise regulated funds should familiarize themselves with the provisions of the Rule and may need to update their valuation procedures to reflect certain requirements of the Rule.

Background

The proper valuation of a fund's investments plays a crucial role in various aspects of a fund's operations, including the determination of a fund's net asset value, which for many funds determines the price at which a fund's shares are offered and redeemed. Valuation of investments also affects the accuracy of a fund's asset-based and performance-based fee calculations and impacts a fund's ability to comply with its investment policies and restrictions. However, the SEC has not formally addressed fund valuation practices since the early 1970s, when it issued Accounting Series Releases Nos. 113 and 118 ("ASRs") which still provide the basis for determination of fair value of securities today, along with guidance from the Financial Accounting Standards Board, particularly ASC Topic 820. The staff of the SEC also has provided guidance on valuation issues through a series of no-action letters.

Section 2(a)(41) of the 1940 Act defines "value" with respect to assets held by registered investment companies.⁵ The definition differentiates between assets for which market quotations are "readily available" and those for which market quotations are not readily available. When market quotations are not readily available, value is defined as fair value as determined in good faith by the fund's board of directors.

The SEC notes in the Adopting Release that since the last comprehensive review of valuation fifty years ago, there have been significant developments in market and investment practices impacting funds and the valuation of their investments, as well as several regulatory changes. Funds now invest in more complex securities that present new valuation challenges. As an example, BDCs, which did not exist when the ASRs were issued, typically invest in the securities of small and middle-market companies that must be fair valued on at least a quarterly basis. Communications and technology advances have also resulted in greater availability of pricing information, as well as greater availability of other data that may be relevant in the valuation process.

The enactment of the Sarbanes-Oxley Act of 2002, which established the Public Company Accounting Oversight Board, the adoption of Rule 38a-1 under the 1940 Act requiring funds to adopt compliance

⁵ Section 59 makes Section 2(a)(41) applicable to BDCs.

policies and procedures (including with respect to fair value) and the issuance of ASC Topic 820 by the Financial Accounting Standards Board all have significantly impacted the fund valuation process. These regulatory developments, coupled with more complex and harder to value securities held by funds, have resulted in boards relying more heavily on the expertise of investment advisers and third-party pricing services in an effort to effectively fulfill the fair value determination obligations set forth in Section 2(a)(41). While boards currently are responsible for determining the methodologies used to fair value fund investments, they typically rely on the adviser and pricing services for the day-to-day calculation of fair values.

Acknowledging the reality of current board practices and the developments discussed above, the Rule provides that the board may designate the fair valuation determination for investments to a valuation designee, subject to oversight of the board and certain reporting and recordkeeping requirements.⁶ It also provides a standardized framework for the actions and functions that are required in order to determine fair value in good faith. In addition, the Rule provides a definition of “readily available market quotation,” which is not otherwise defined in the 1940 Act or the rules thereunder.

Performance of Fair Value Determinations

As noted above, the board of a fund is responsible for determining in good faith the fair value for fund investments for which market quotations are not readily available.⁷ The Adopting Release acknowledges that boards typically are not involved in the day-to-day valuation tasks that would be required to determine fair value and instead in practice often allocate this function to the fund’s adviser, subject to the board’s supervision. In acknowledging this practical reality, the Rule allows the board to designate the actual fair value determination to a valuation designee which would carry out the functions described in the above section, subject to the board’s oversight.

Oversight. The Adopting Release makes it clear that, even where a board has designated fair value determination to a valuation designee, the board retains responsibility for active oversight of such valuation designee. The Adopting Release notes that boards should approach this oversight with a “skeptical and objective view,” particularly with respect to valuation risks and potential conflicts of interest. The Adopting Release encourages board members to seek out and review relevant information as may be necessary to be fully informed about the fund’s fair value process. It also notes that the SEC expects that boards will utilize an appropriate “level of scrutiny” based on the fund’s valuation risk, and that this scrutiny should be proportionate to the level of subjectivity involved in determining fair value for an investment. The Adopting Release notes the expectation that boards will periodically review the financial resources, technology, staff and expertise of the valuation designee, as well as the reasonableness of the valuation designee’s reliance on other fund service providers, with an aim to evaluate the appropriateness of the fair value process.

The Adopting Release also focuses on concerns relating to potential conflicts of interest that may arise as a result of the adviser or other service providers having incentives to improperly value fund assets. It notes that a fund’s adviser may benefit from improper valuations, which could increase fees or improve

⁶ Unit investment trusts, which do not have a board of directors, can designate the fair value determination to the trust’s trustee or depositor under the Rule.

⁷ See Section 2(a)(41)(B)(ii) of the 1940 Act. In ASR 118, the SEC acknowledged that the board may appoint a person to assist with the determination of fair value, but the findings must still be reviewed carefully by the board.

returns. In particular, the Adopting Release admonishes boards to seek to identify potential conflicts of interest, monitor such conflicts and take reasonable steps to manage such conflicts.

Board Reporting. Pursuant to the Rule, a valuation designee that the board has designated to perform fair value determinations must provide to the board certain periodic reports and prompt notification and reporting on matters materially affecting the fair value of investments. On a quarterly basis, the valuation designee must provide a summary or description of material fair value matters occurring during the prior quarter, as well as any other information requested by the board.⁸ The valuation designee must also provide the board a written assessment of the adequacy and effectiveness of the valuation designee's fair valuation process, on at least an annual basis.⁹ The valuation designee must also provide prompt reporting to the board (within five business days) on matters that could materially affect the fair value of investments.¹⁰ As noted in the Adopting Release, a board must also inquire about any material matters of which the board becomes aware, and take reasonable steps to ensure they are addressed.

Specify Responsibilities. If fair value determination is designated to a valuation designee, the valuation designee must specify the titles and functions of the persons responsible for determining the fair value of the investment, and must reasonably segregate the process of making fair value determinations from the portfolio management of the fund, in order to avoid potential conflicts of interest. Although the Adopting Release notes that portfolio managers may have relevant insight into the process for determining fair value for investments, the inherent conflicts of interest that are present because portfolio management personnel are usually compensated based on the returns of the fund make it inappropriate for a portfolio manager to make the fair value determination. The Rule specifies that a portfolio manager may not determine, or effectively determine by exerting substantial influence on, the fair values of portfolio investments.

Fair Value Determination Under The Rule

In order to determine fair value in good faith of a fund's investment, as required by Section 2(a)(41), the Rule lays out the following actions and functions that are required to be undertaken either by the board, or if the board has designated fair value determination to a valuation designee, by the valuation designee:

Assess and Manage Valuation Risks. The Rule requires the periodic assessment of material risks associated with valuation. The Adopting Release includes a non-exhaustive list of examples of the types and sources of such risks, including the types of investments held or intended to be held by a fund, potential market or sector dislocations, the extent to which unobservable inputs are utilized in the valuation methodology and reliance on service providers and limitations of their experience. The Rule

⁸ This summary must include any material changes in the assessment and management of valuation risks, including any material changes in conflicts of interest of the valuation designee, any material changes to, or material deviations from, the fair value methodologies, and 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.

⁹ These reports must include, at a minimum, a summary of the results of the testing of fair value methodologies required under the Rule, and an assessment of the adequacy of resources allocated to the process for determining the fair value of designated investments, including any material changes to the roles or functions of the persons responsible for determining fair value.

¹⁰ Material matters include 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.

does not prescribe the specific valuation risks to be addressed, and instead requires that this assessment be based on the facts and circumstances of an individual fund's investments. While a fund's valuation risks should be re-assessed periodically, the Rule does not set a specific required frequency for assessment, which should instead depend on changes in fund investments or in a fund's strategy or policies, among other things.

Establish and Apply Fair Value Methodologies. The Rule requires that an appropriate fair value methodology be selected and applied in a consistent manner to determine the fair value of investments.¹¹ In this regard, the key inputs and assumptions specific to each asset class or portfolio holding held by the fund must be specified. In addition, the appropriateness and accuracy of the selected methodologies must be reviewed periodically and adjusted as necessary. Methodologies established by a fund to value investments may be changed if different methodologies are shown to be equally or more representative of the fair value of the investments, and investments within the same asset class may be valued utilizing different appropriate methodologies. In a change from the rule as proposed, a board or valuation designee will not be required to consider the applicability of the selected fair value methodologies to types of fund investments that a fund does not yet hold but intends to hold in the future. In addition, unlike the proposed rule, the Rule does not require the establishment of criteria for determining when market quotations are no longer reliable and therefore not considered readily available.

Test Fair Value Methodologies. Once selected, the appropriateness and accuracy of the fair value methodologies must be tested, with the Rule requiring the identification of testing methods to be used and minimum frequency of testing. However, the Rule does not prescribe the specific testing methods or frequency of testing that should be undertaken, and instead such matters will depend on the facts and circumstances of each fund, as determined by the board or the adviser. The Adopting Release notes that the results of calibration and back-testing can be particularly useful and can help identify issues with methodologies applied by fund service providers.¹² However, the Rule does not specifically require the use of calibration or back-testing.

Evaluate Pricing Services. The Adopting Release notes that, particularly with respect to more complex assets, funds may rely on valuation information provided by third-party pricing services. The Rule requires the oversight and evaluation of such pricing services by the fund's board or valuation designee, including the establishment of a process for the approval, monitoring and evaluation of each pricing service provider and instituting a process for initiating price "challenges" (i.e., where a fund disagrees with a price provided by a pricing service).¹³

¹¹ The Adopting Release notes that in order to be appropriate under the Rule, a methodology must also be consistent with ASC Topic 820, which covers various valuation approaches and techniques, and should maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

¹² Calibration refers to the process of monitoring for material differences between the price paid for a fair-valued holding as compared to the price calculated for such holding at the time of acquisition by the fund's fair value methodology. Back-testing compares the fair value of a fund's investment to observed transaction or other market information, including quotes from dealers or pricing services data.

¹³ The Adopting Release notes certain factors that should be considered in such an oversight process, including, among other things: (i) the qualifications, experience and history of the pricing service; (ii) the valuation methods or techniques, inputs, and assumptions used by the pricing service for different asset classes; (iii) the quality of the pricing information provided by the service and the extent to which the service determines its pricing information as close as possible to the time as of which the fund calculates its net asset value; (iv) the process for considering price challenges; (v) potential conflicts of interest of the pricing service and the steps the pricing service takes to mitigate such conflicts; and (vi) the testing processes used by the pricing service.

Fair Value Policies and Procedures. In a departure from the rule as proposed, the Rule does not include a separate requirement that a fund adopt written policies and procedures reasonably designed to achieve compliance with the requirements of the Rule. Instead, the Adopting Release explains that Rule 38a-1 under the 1940 Act, which requires a fund's board to approve the fund's policies and procedures and those of each adviser and other specified service providers, will by its terms require the adoption and implementation of written policies and procedures reasonably designed to prevent violations of the Rule. The Adopting Release also states that the fair value policies and procedures must be approved by a fund's board pursuant to Rule 38a-1 and may not be considered material amendments to existing fair value policies and procedures.

Notably, many of the above actions and requirements have previously been implemented by illiquid-focused funds, such as BDCs, which often utilize a committee of independent directors, either through the Audit Committee or a separate Valuation Committee, to oversee the fund's valuation process. In many cases, this board committee is tasked with approving, among other things, the engagement of third-party pricing services and changes to a fund's valuation policies and procedures. This group of independent directors also often previews with a fund's adviser and any third-party pricing services proposed valuations of illiquid investments prior to board determination of fair value.

Other Provisions of the Rule and Related Matters

Recordkeeping

Along with the Rule, the SEC has also adopted Rule 31a-4 under the 1940 Act, relating to recordkeeping requirements in connection with fair value determinations. Rule 31a-4 requires a fund to maintain documentation supporting fair value determinations for at least six years from the time the determination was made (the first two years in an easily accessible place). A fund must maintain such records unless the fund's board has designated the performance of fair value determinations to the fund's investment adviser, in which case the investment adviser is required to maintain the records.

Readily Available Market Quotations

As discussed above, for purposes of determining value of an investment, Section 2(a)(41) of the 1940 Act differentiates between whether market quotations are "readily available" or not, but this term is not defined in the 1940 Act or the rules thereunder. The Rule defines a market quotation as being "readily available" for purposes of the 1940 Act only when the 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. The Adopting Release notes that a quote would be considered unreliable under the Rule in circumstances where it would require adjustment under U.S. Generally Accepted Accounting Principles ("U.S. GAAP") or where U.S. GAAP would require consideration of additional inputs in determining the value of the security. If a market quotation is not available, a fair value methodology must be utilized in valuing the investment, and such methodology must also be determined in accordance with U.S. GAAP. The Adopting Release also notes the potential impact of the adoption of the definition of "readily available" on current cross trade practices under Rule 17a-7 under the 1940 Act, given that a security must have a readily available market quotation in order to cross trade under that rule.¹⁴

¹⁴ The Adopting Release states that the definition of readily available market quotations will apply in all contexts under the 1940 Act, including Rule 17a-7, and acknowledges that certain securities may no longer be viewed as having readily available market quotations and will not be

Rescission of Prior Commission Releases and Withdrawal of No-Action Letters

As noted in the Adopting Release, the SEC recognizes that, in light of more recent accounting standards and pronouncements, previous SEC guidance, including ASR 113 and ASR 118, as well as certain no-action letters relating to valuation, are no longer necessary and are being rescinded or withdrawn. In addition, certain guidance on thinly traded securities and the use of pricing services issued in 2014 is being rescinded.¹⁵

Transition Period

The effective date of Rules 2a-5 and 31a-4 is 60 days following their publication in the Federal Register. In order to provide funds and valuation designees with sufficient time to comply with the new rules, the compliance date for the rules is 18 months after the effective date, at which point funds must comply with the new rules and the SEC guidance referenced above will be rescinded. A fund may opt to comply with Rules 2a-5 and 31a-4 any time after the effective date, but in so doing may only rely on the rules and not on any SEC or staff guidance that will be withdrawn or rescinded on the compliance date.

Impact of the Rule on Boards and Advisers

The Rule represents an effort to formalize a more realistic allocation of responsibility for fair value determination as between a fund's board and its adviser. The Rule has the potential to significantly streamline the fair value process for certain funds that may only hold illiquid investments on an infrequent basis, and may aid open-end funds in better handling their determination of daily net asset value when they hold one or more illiquid investments from time to time. However, as the Rule and the Adopting Release make clear, a board that designates fair value determination to the adviser still retains substantial responsibility to oversee and assess the valuation process. In addition, the Rule requires a delineation between the valuation and portfolio management functions at the adviser level if a board opts to delegate fair value determinations in accordance with the Rule. As a result, BDCs and other funds that invest primarily in illiquid assets may be less likely to take advantage of the delegation of fair value determinations afforded under the Rule, particularly in view of the robust board procedures such funds typically already have in place to handle quarterly valuations.

The Rule also prescribes the information that must be reported by a valuation designee to a board in the case of designation, including relating to any material conflicts of interest an adviser (or other service provider) may encounter in the valuation process and to the adequacy of the resources allocated to the valuation process. In addition, the Rule sets out specific responsibilities of boards and advisers with respect to oversight and evaluation of pricing services. Therefore, while the Rule should help to improve the overall valuation process, it may require boards and advisers to make changes to their current valuation processes to meet the functions and requirements specified in the Rule. In addition, the Rule will eliminate certain flexibility with respect to valuation that funds and boards currently enjoy, given the significant number of requirements in the Rule.

available to cross trade under Rule 17a-7. However, the Adopting Release also notes that consideration of potential revisions to Rule 17a-7 is on the SEC's rulemaking agenda and that public input on this matter is welcome.

¹⁵ Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014).

Impact of the Rule on Private Funds

While the Rule applies only to funds regulated under the 1940 Act, there are certain elements of the Rule and the Adopting Release that could be viewed as best practices for all advisers to consider adopting, particularly with respect to potential conflicts of interest in the valuation process. It can be beneficial for the adviser's fair value determination function to be segregated from the portfolio management of that fund to the extent possible, in order to avoid potential conflicts of interest. Investment advisers may find it challenging to separate their portfolio management personnel from those making fair value determinations, not only from a resources perspective but also in view of the detailed knowledge a fund's portfolio manager likely has with respect to the illiquid investments a fund holds. The definition of readily available market quotations contained in the Rule can also provide additional clarity to advisers of private funds, and the requirement to evaluate and monitor pricing services in the Rule provides a reminder to all advisers of the importance of doing so.

Next Steps

Funds and their boards and advisers should begin to familiarize themselves with the requirements of the Rule and consider whether designation to perform fair value determinations to a valuation designee is appropriate. In addition, funds that currently engage in cross trades under Rule 17a-7 should assess whether the definition of "readily available market quotations" in the Rule will impact such trading practices.

Authored by [John J. Mahon](#), [Karen Spiegel](#) and [Noah B. Aschen](#).

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com

This communication is issued by Schulte Roth & Zabel LLP for informational purposes only and does not constitute legal advice or establish an attorney-client relationship. In some jurisdictions, this publication may be considered attorney advertising. ©2020 Schulte Roth & Zabel LLP. All rights reserved. SCHULTE ROTH & ZABEL is the registered trademark of Schulte Roth & Zabel LLP.