

The background of the entire page is a blurred image of a laptop screen displaying various financial charts, including a candlestick chart at the top and a bar chart below it. A hand is visible in the lower right, holding a pen and pointing at the bar chart. The overall color scheme is a mix of dark blues and greens.

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SEC Adopts New Framework for Fund Valuation

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SEC Adopts New Framework for Fund Valuation

By John S. Marten, Jacob C. Tiedt, Nathaniel Segal and Kelly Pendergast Carr

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On December 3, 2020, the U.S. Securities and Exchange Commission adopted new Rule 2a-5 under the Investment Company Act of 1940 (the “1940 Act”) providing a new framework for fund valuation practices and clarity on how fund boards may satisfy their statutory obligation to determine the fair value of fund investments. In particular, new Rule 2a-5:

- permits fund boards to designate the fund’s investment adviser (or, for internally managed funds, a fund officer) as the party that performs determinations of fair values of fund investments (in this capacity, the “valuation designee”), subject to board oversight, without any requirement that boards subsequently ratify any fair values so determined by the valuation designee;
- establishes a principles-based framework for determining fair values of fund investments that incorporates the assessment and management of material valuation risks, the establishment, application and testing of fair valuation methodologies, and enhanced oversight of pricing services;
- requires periodic reporting by the valuation designee to facilitate board oversight; and
- formally defines when market quotations are “readily available” for purposes of the 1940 Act.

In addition, the SEC issued significant new guidance concerning various aspects of Rule 2a-5, including, among other things, examples of specific sources of valuation risk. The SEC also set forth its expectations regarding fund directors’ oversight responsibilities with respect to valuation matters, which are discussed in Section IV. A. below. Finally,

the SEC also adopted new Rule 31a-4, which establishes certain recordkeeping requirements associated with fair value determinations under Rule 2a-5.

Rule 2a-5 applies to all investment companies registered under the 1940 Act, including investment companies structured as unit investment trusts, and business development companies. While Rule 2a-5 and the related recordkeeping requirements of Rule 31a-4 will become effective 60 days from publication in the Federal Register (anticipated in early 2021), compliance with the new rules will not be required until 18 months after the effective date.

I. Background, Regulatory Approach and Differences from the Proposed Rule

Under the 1940 Act, securities held by a fund for which market quotations are “readily available” are to be valued at current market value, and securities for which market quotations are not readily available are to be valued at fair value as determined in good faith by the fund’s board. The SEC last comprehensively addressed valuation almost 50 years ago.¹ Since then, the growing complexity of funds’ investments, expansion of the fund industry and regulatory developments in accounting and compliance have altered the way funds and their boards approach the fair valuation of fund investments.

In response to the need for a modernized valuation framework, the SEC proposed Rule 2a-5 in April 2020. Following public comment, the SEC adopted final Rule 2a-5 in December 2020 with certain modifications. Key differences between the proposed and final forms of Rule 2a-5 are as follows:

- Final Rule 2a-5 excludes certain prescriptive elements of the proposed rule and provides more flexibility to boards or their valuation designees to exercise judgment in the valuation process.²
- Final Rule 2a-5 provides that the board may “designate,” rather than “assign,” the performance of fair valuation determinations to a valuation designee. This change was intended by the SEC to underscore that the valuation designee performs valuation determinations on the board’s behalf and subject to board oversight.
- Other notable changes from the proposed rule include: (i) a requirement that a board’s valuation designee be the fund’s primary adviser (i.e., not a fund’s sub-adviser);³ (ii) certain modifications to the required reporting by a valuation designee to the fund’s board; (iii) certain changes to the requirements for selecting and applying fair value methodologies; and (iv) a clarification that the newly adopted definition of “readily available” market quotations applies in all contexts under the 1940 Act, including with respect to cross trades under Rule 17a-7.
- Finally, in a change from the proposal, final Rule 31a-4 does not require that detailed records be kept relating to specific methodologies and inputs used by pricing services in making fair valuation determinations.

II. Designation of Performance of Fair Value Determinations

Under Rule 2a-5, a fund’s board, or a committee thereof, may retain responsibility for determining the fair value in good faith of fund investments for which market quotations are not readily available, or the board may designate the performance of fair value determinations for some or all fund investments to the fund’s primary investment adviser (or, in the case of an internally managed fund, a fund officer). The board may not designate this responsibility to sub-advisers or other service providers.

If the board appoints a valuation designee to make fair value determinations in reliance on Rule 2a-5, the board is not

required to subsequently ratify any fair value determinations so made. However, if a valuation designee is appointed, certain additional requirements concerning board oversight and board reporting apply. Details concerning these requirements are set forth below in Section IV.

III. Determining Fair Value in Good Faith

Rule 2a-5 provides that determining fair value in good faith, consistent with the standards of the 1940 Act, requires a fund’s board or its valuation designee to (i) periodically assess and manage valuation risks, (ii) establish, apply and periodically test fair valuation methodologies and (iii) evaluate and oversee pricing services.

A. Periodically Assess and Manage Valuation Risks. A fund’s board or its valuation designee must assess periodically any material risks associated with the determination of the fair value of fund investments, including material conflicts of interest, and manage those identified valuation risks.

- *How to Assess Valuation Risk.* The SEC states in the adopting release that a fund’s specific valuation risks depends on the facts and circumstances of the particular fund’s investments. Rule 2a-5 provides flexibility to determine whether certain sources and types of valuation risk should be weighed more heavily than others.
- *Types of Valuation Risks.* The adopting release includes a non-exhaustive list of the types or sources of valuation risk, including:
 - the types and characteristics of investments held or intended to be held by the fund;
 - potential market or sector shocks or dislocations and other types of disruptions that may affect the ability of a valuation designee or other third party to operate;
 - the extent to which a fair value methodology uses unobservable inputs, in particular if such inputs are provided by the valuation designee;
 - the proportion of the fund’s investments that are fair valued and the contribution of those investments to the fund’s returns;

- reliance on service providers that have more limited expertise in relevant asset classes;
 - the use of fair value methodologies that rely on inputs from third-party service providers, and the extent to which those third-party service providers rely on their own service providers (known as “fourth-party” risks); and
 - the risk that methodologies for determining and calculating fair value may be inappropriate or that those methodologies may be applied inconsistently or incorrectly.
- *Frequency of Periodic Reassessment.* Rule 2a-5 does not prescribe a minimum frequency for the reassessment of valuation risk. However, according to the adopting release, periodic reassessment of valuation risk generally should take into account:
 - (i) changes in fund investments, (ii) significant changes in a fund’s investment strategies or policies, (iii) market events and (iv) any other relevant factors.

B. Establish and Apply Fair Value Methodologies. Under Rule 2a-5, a fund’s board or its valuation designee must establish and apply fair value methodologies. To satisfy this requirement, a board or its valuation designee, as applicable, must:

- *Select and Apply Appropriate Fair Value Methodologies.* A fund’s board or its valuation designee must select and apply, in a consistent manner, appropriate methodologies for determining (which includes calculating) the fair value of fund investments. This includes specifying the key inputs and assumptions specific to each asset class or portfolio holding.

Rule 2a-5 provides fund boards or their valuation designees flexibility in applying selected methodologies. In particular, the rule permits selected methodologies to be changed or adjusted if different methodologies are at least equally representative of the fair value of the investments and does not prohibit the use of different methodologies for investments within the same asset class. The SEC stated in the adopting release that determination of a fair value is dependent on the facts

and circumstances of a particular investment and that there is no single methodology for determining the fair value of an investment; rather, there may be a range of appropriate values that could reasonably be considered to be the fair value. In addition, in a change from the proposed rule, final Rule 2a-5 does not require funds to preemptively determine valuation methodologies for investments in which a fund may, but does not currently, invest.⁴

- *Periodically Review Appropriateness and Accuracy of Selected Fair Value Methodologies.* A fund’s board or its valuation designee must review periodically the selected fair value methodologies for appropriateness and accuracy, and make changes or adjustments to the methodologies as needed.
- *Monitor for Circumstances that May Necessitate the Use of Fair Value.* In a change from the proposed rule, final Rule 2a-5 does not require a board or its valuation designee to establish criteria for determining when market quotations are no longer reliable and therefore are not readily available. However, a fund’s board or its valuation designee must monitor for circumstances that may necessitate the use of fair value. The adopting release cites as an example securities that trade in foreign markets, which should be monitored for significant events after market close that may impact valuation.

C. Testing of Fair Value Methodologies. Rule 2a-5 requires periodic testing of the appropriateness and accuracy of the methodologies used to calculate fair value.

- *Methods and Frequency.* To satisfy the testing requirement a board or its valuation designee must identify appropriate testing methods and provide for a minimum frequency of testing. Rule 2a-5 does not specify any particular testing methods to be used or a minimum frequency for conducting tests; rather, these will vary depending on a fund’s particular circumstances and will be determined by the board or its valuation designee.

- *Calibration and Back-Testing.* In the adopting release, the SEC stated that calibration and back-testing are “examples of 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.” The SEC noted that these methods should be used in many instances to test the appropriateness and accuracy of fair value methodologies. However, Rule 2a-5 neither requires the use of these testing methodologies nor precludes the use of other appropriate methodologies.

D. Oversight of Pricing Services. Under Rule 2a-5, determining fair value in good faith also requires the oversight of any pricing services, including establishing a process for approving, monitoring and evaluating pricing services.

- *Oversight of Pricing Services.* The SEC did not adopt a specific requirement to review the selection of pricing services; however, in the adopting release the SEC notes that in cases in which a fund’s board has appointed a valuation designee, the valuation designee should, as part of the annual report to the board on the adequacy and effectiveness of the fair valuation process, consider the adequacy and effectiveness of any pricing services used. The process for initiating price challenges established by the valuation designee is also subject to appropriate board oversight.
- *Guidance on Selection of Pricing Services.* In the adopting release for Rule 2a-5, the SEC states that a board or its valuation designee generally should take into consideration the following factors when selecting a pricing service:
 - the qualifications, experience and history of the pricing service;
 - the valuation methodologies or techniques, inputs and assumptions used by the pricing service for different investments and how they may be affected as market conditions change;

- the quality of the pricing information provided by the pricing service and the extent to which the pricing service makes pricing determinations as close as possible to the time at which the fund calculates its net asset value;
- the pricing service’s process for addressing price challenges, including how the pricing service incorporates information received through price challenges into its pricing information;
- the pricing service’s actual and potential conflicts of interest and steps taken to mitigate those conflicts; and
- the pricing service’s testing processes.

In addition, in the adopting release, the SEC stated that a fund’s board or its valuation designee generally should take into account the appropriateness of using information from a pricing service in determining the fair values of a fund’s investments under circumstances in which, for example, the board or valuation designee lacks a good faith basis for believing that the pricing service’s methodologies produce prices that reflect fair value.

- *Process for Initiating Price Challenges.* Under Rule 2a-5, a fund’s board or its valuation designee must establish a process for initiating price challenges, representing a change from the proposed rule, which would have required the establishment of criteria for initiating price challenges. In the adopting release, the SEC notes that there may be a range of circumstances under which initiating a price challenge may be appropriate, and that pre-established criteria likely would not be able to account for all such circumstances.

E. Fair Valuation Policies and Procedures. Rule 2a-5 does not include proposed provisions that would have required a fund to adopt separate written policies and procedures reasonably designed to achieve compliance with the requirements of the rule. Instead, Rule 38a-1 by its terms requires the adoption and implementation of written policies and procedures reasonably designed to prevent violations of the requirements of Rule 2a-5. When a board retains

responsibility to make fair value determinations, the fund must adopt and implement new procedures under Rule 38a-1 to address Rules 2a-5 and 31a-4. However, when a board designates a valuation designee to make those determinations, the valuation designee must adopt and implement such policies and procedures, and the fund need not separately adopt its own duplicative policies and procedures. In either case, policies and procedures adopted by either the fund or the valuation designee to address Rules 2a-5 and 31a-4 are considered “new” procedures under Rule 38a-1, rather than amendments to existing procedures, and must be approved by the fund’s board.

IV. Additional Requirements if a Valuation Designee Is Used

Under Rule 2a-5, if a fund’s board appoints a valuation designee to make fair value determinations for a fund, the following additional guidance related to board oversight and requirements for board reporting will apply.

A. Board Oversight. In the adopting release for Rule 2a-5, the SEC provided the following guidance to fund directors regarding the SEC’s expectations for board oversight of the valuation process assigned to a valuation designee:

- *Skeptical and Objective Oversight.* Boards should approach their oversight of fair value determinations assigned to a valuation designee with a skeptical and objective view that takes into account a fund’s particular valuation risks, including with respect to conflicts of interest, the appropriateness of the fair value determination process and the skill and resources devoted to it.
- *Active Oversight.* Effective board oversight cannot be a passive activity. Directors should ask questions and seek relevant information, particularly when there are red flags or other indications of problems. Oversight should be an iterative process that seeks to identify potential issues and opportunities to improve the fund’s fair value processes. Boards should request follow-up information when appropriate and take reasonable steps to see that matters identified are addressed.

- *Scrutiny of Subjective Inputs.* Board scrutiny of the valuation process should be appropriately calibrated to a fund’s valuation risks, including the extent to which fair value determinations depend on subjective inputs. As the level of subjectivity of inputs and assumptions increases, the level of board scrutiny should increase correspondingly.
- *Management of Conflicts of Interest.* It is incumbent upon boards—consistent with their obligations under the 1940 Act and as fiduciaries—to seek to identify conflicts of interest, monitor such conflicts and take reasonable steps to manage such conflicts. Boards should serve as a meaningful check on the conflicts of interest of the valuation designee and other service providers involved in the fair valuation process. Boards are advised to critically review the information provided to them, particularly with regard to the valuation designee’s reporting on its own conflicts of interest.
- *Periodic Reviews of the Valuation Designee’s Processes.* Boards should probe the appropriateness of the valuation designee’s fair value processes, including the adequacy of resources supporting fair value functions, such as financial, technology, compliance and personnel resources and expertise as well as the reasonableness of the valuation designee’s reliance on other service providers in this respect.
- *Nature of Board Reporting.* Boards should consider the type, content and frequency of the reports they receive. Boards should request and review such information as may be necessary to be informed of the valuation designee’s fair valuation processes.

B. Board Reporting. The valuation designee must report to the board about its performance of responsibilities under Rule 2a-5, including certain periodic reports and prompt notification and reporting on matters that materially affect the fair value of fund investments.

- *Quarterly Reporting.* Rule 2a-5 requires the valuation designee, at least quarterly, to provide the board with a

written summary or description of material fair value matters that occurred in the prior quarter, including:

- any material changes in how the valuation designee assesses and manages valuation risks, including any material changes in conflicts of interest involving the valuation designee or any other relevant service provider;
 - any material changes to, or material deviations from, the fair value methodologies established pursuant to Rule 2a-5;
 - any material changes to the valuation designee’s process for selecting and overseeing pricing services and any material events related to the valuation designee’s oversight of pricing services; and
 - any other reports or materials requested by the board related to determining fair values of fund investments or the valuation designee’s process for determining fair values.
- **Annual Reporting.** The valuation designee must provide at least annually a written assessment of the adequacy and effectiveness of the valuation designee’s process for determining the fair value of the fund’s investments. At a minimum, this report must include:
 - a summary of the results of testing of fair valuation methodologies; and
 - an assessment of adequacy of resources allocated to the fair value process, including any material changes to the roles or functions of persons responsible for determining fair values.

The annual reporting requirements represent a change from the proposed rule, which would have required reporting on these items on a quarterly basis. In a further change, Rule 2a-5 does not require reporting on the results of all valuation testing, but instead only requires a summary.

- **Prompt Board Notification and Reporting.** The valuation designee must provide written notification to the board of the occurrence of matters that materially affect the fair value of fund investments no later than five business days after the valuation designee becomes aware of the

material matter. In a change from the proposed rule, Rule 2a-5 will also provide a valuation designee 20 business days from becoming aware of a valuation matter to determine whether the matter is material. The proposed rule would have provided valuation designees with three business days.

- **Guidance on Material Matters.** In the adopting release, the SEC noted that material matters requiring prompt reporting would generally be those matters about which the board would reasonably need to know to exercise appropriate oversight of the valuation designee’s process for determining fair values. Examples that the SEC provided 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, as well as appropriate follow-up reports on these matters.
- **Form of Board Reporting.** The valuation designee’s reports must include information reasonably necessary for the board to evaluate the matters covered in the reports. In the adopting release, the SEC suggested that boards work with valuation designees to determine the scope and format of information that would be most useful to the board in its conduct of oversight, subject to the minimum content requirements discussed above. These reports may take the form of narrative summaries, graphical representations, statistical analyses, dashboards or exceptions-based reporting, among other methods. The SEC agreed that “boards should have latitude to implement a flexible reporting mechanism that is tailored to their fund, recognizes judgment in exercising oversight, and minimizes rote reporting.”

C. Specification of Functions. The fair valuation policies and procedures adopted to comply with Rule 2a-5 should specify the titles of the persons responsible for determining the fair value of the designated investments and should specify the particular functions for which the identified persons are responsible, including those with duties

associated with price challenges and with the authority to override a price.

- **Use of Committees.** If the valuation designee uses a valuation committee or similar body to assist in the process of determining fair value, the fair value policies and procedures generally would describe the composition and role of the committee, or reference any related committee governance documents as appropriate.
- **Reasonable Segregation from Portfolio Management.** Rule 2a-5 requires the valuation designee to reasonably segregate fair value determinations from portfolio management. Under Rule 2a-5, to satisfy the reasonable segregation requirement, a portfolio manager may not determine, or effectively determine “by exerting substantial influence,” fair valuations. The valuation designee should tailor the segregation of functions to the valuation designee’s particular facts and circumstances, taking into account the valuation designee’s size and resources.

D. Guidance on Obtaining the Assistance of Others. In response to requests from commenters, the SEC clarified that a valuation designee may obtain assistance from others, such as pricing services, fund administrators, sub-advisers, accountants or counsel in fulfilling fair value duties, such as back-testing and calculations required by the valuation methodology selected by the valuation designee. However, in the adopting release, the SEC emphasized that a valuation designee would remain responsible for making fair value determinations and may not designate or assign that responsibility to a third party.

V. Recordkeeping

Along with Rule 2a-5, the SEC also adopted new Rule 31a-4 to establish certain recordkeeping requirements associated with the fair value activities conducted in reliance on Rule 2a-5. Records are generally required to be maintained for six years, the first two in an easily accessible place, either by the fund or the valuation designee.

A. Records Required to Be Maintained. Rule 31a-4 requires that funds or the valuation designee maintain: (i) appropriate documentation to support fair value determinations; (ii) reports to the fund’s board required under Rule 2a-5; and (iii) a specified list of the investments or investment types whose fair value determination has been designated to the valuation designee.

B. Guidance regarding Appropriate Documentation to Support Fair Value Determinations. In a change from the proposed rule, final Rule 2a-5 does not require detailed records relating to specific methodologies and inputs used in making a fair valuation determination. The SEC indicated that appropriate documentation “should include documentation that would be sufficient for a third party, such as the SEC staff, not involved in the preparation of the fair value determinations, to verify, but not fully recreate, the fair value determination.” The SEC acknowledged that different types of records may be appropriate depending on the security, methodology or subjectivity of inputs used.

- The SEC provided the following examples of documentation that may be appropriate to support fair value determinations in certain instances:
 - schedules evidencing and supporting each computation of net asset value as required under Rule 31a-2;
 - copies of internally developed valuation models, including inputs and assumptions and supporting documentation;
 - work papers documenting price challenges, stale price analyses and testing, such as calibration or back-testing; and
 - with respect to a fair valuation provided by a pricing service, records related to the initial due diligence and ongoing monitoring and oversight of the pricing service.

VI. “Readily Available” Market Quotations

Under the 1940 Act, a fair value determination must be made when a market quotation for an investment is not “readily

available.” Rule 2a-5 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.”⁵

A. Guidance on “Readily Available” Market Quotations.

The adopting release provided the following guidance as to whether certain prices would be considered to meet the definition outlined in Rule 2a-5:

- *Exchange Adjusted Prices.* The adopting release clarifies that an “unadjusted” price includes prices for securities that are adjusted by the exchange on which the security is listed.
- *Evaluated Prices.* Evaluated prices, indications of interest and accommodation quotes would not be considered “readily available” market quotations for purposes of Rule 2a-5.
- *Net Asset Values of Certain Pooled Investment Vehicles.* Securities of pooled investment vehicles that publish their net asset values daily and issue and redeem shares at that net asset value (such as mutual funds) are generally consistent with the definition of having “readily available” market quotations under Rule 2a-5.

B. Definition of Readily Available Market Quotations and

Cross Trades under Rule 17a-7. The definition of readily available market quotations adopted in Rule 2a-5 applies in all contexts under the 1940 Act, including with respect to cross trades under Rule 17a-7. The SEC acknowledged that certain securities that previously had been viewed as having readily available market quotations may not meet the new definition and thus would not be available for cross trades. The SEC also noted that many cross trades are done in reliance on certain no-action letters issued by the SEC staff and cited certain letters that allow for cross trades in municipal securities when transaction prices are provided by an independent pricing service. The adopting release states that the staff is reviewing these letters to determine whether they should be withdrawn.

VII. Rescission of Current SEC Guidance

With the adoption of Rule 2a-5, the SEC rescinded Accounting Series Release 113, issued in 1969, and Accounting Series Release 118, issued in 1970, in which the SEC provided guidance on, among other things, the role of a fund’s board in making fair value determinations, as well as on certain related accounting and auditing matters. In addition, guidance contained in the adopting release for Rule 2a-5 supersedes certain guidance in the SEC’s 2014 Money Market Fund Release regarding the oversight of pricing services and the valuation of thinly traded securities.⁶ However, other portions of the Money Market Fund Release remain in effect.⁷ Furthermore, certain other SEC staff letters and other staff guidance related to the fair value process are withdrawn or rescinded.

VIII. Implementation and Transition Period

Rule 2a-5 and the related recordkeeping requirements of Rule 31a-4 will become effective 60 days from publication in the Federal Register (anticipated in early 2021). However, compliance with the new rules will not be required until 18 months after the effective date. Once the rules become effective, funds may voluntarily comply in advance of the compliance date; however, funds doing so must rely only on the new rules in connection with fair value determinations and may not also consider SEC staff letters or other guidance that will be rescinded at the end of the 18-month transition period.

The adopting release is available [here](#).

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ENDNOTES

1. See Securities and Exchange Commission Codification of Financial Reporting Policies, Statement Regarding “Restricted Securities,” Investment Company Act Release No. 5847 (Oct. 21, 1969); Investment Companies, Investment Company Act Release No. 6295 (Dec. 23, 1970).
2. In this regard, the SEC declined to adopt the “safe harbor” approach suggested by some commenters and instead established a minimum and baseline standard to fair value investments in good faith. The SEC also declined to confirm that boards may provide oversight of the performance of fair value determinations consistent solely with the business judgment rule under state law.
3. For funds that are internally managed, an officer of the fund may serve as valuation designee.
4. To be appropriate under Rule 2a-5, and in accordance with current accounting standards, a methodology that is used to determine the fair value of a fund’s investments must be consistent with FASB Accounting Standard Codification Topic 820: Fair Value Measurement (“ASC Topic 820”), and thus derived from the market approach, the income approach or the cost approach. Supplemental methodologies for situations not explicitly outlined in ASC Topic 820 may be appropriately applied by boards or valuation designees, provided that the methodologies are not inconsistent with the principles outlined in ASC Topic 820. Furthermore, in describing the particular fair value methodologies to be used, the SEC states that it would not be sufficient simply to state that private equity investments are valued using a discounted cash flow model, or that options are valued using a Black-Scholes model, without providing any additional 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).
5. The adopting release notes that the definition outlined in Rule 2a-5 is consistent with the definition of a Level 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 Level 1 inputs.
6. Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014).
7. See Investment Company Act Release No. 34128 (Dec. 3, 2020) at § II.D.-E.

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