



Investment Management ADVISORY ■

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SEC Proposes New Fund Valuation Rule Under the Investment Company Act

The Securities and Exchange Commission (SEC) issued a [proposal](#) on April 21, 2020 that would create new Rule 2a-5 under the Investment Company Act of 1940, as amended. Proposed Rule 2a-5 would apply to all registered investment companies and business development companies (collectively, “funds”) and, if adopted, would provide more specific guidelines for the fair value determination of fund assets and allow fund boards to assign such determinations to the fund’s investment adviser, subject to board oversight and certain other conditions. The comment period for the proposal will remain open until July 21, 2020.

Required Board Functions Under New Rule 2a-5

Pursuant to Section 2(a)(41) of the 1940 Act, funds must determine the value of their portfolio assets using either (1) the market value of their portfolio securities when market quotations are readily available; or (2) when market quotations are not readily available, the fair value of such securities or assets as determined in good faith by the fund’s board of directors. The Proposed Rule would address the latter by setting out the following functions a fund board (or designated investment adviser) must perform to make a good-faith determination of fair value.

Assess and manage risks

The Proposed Rule would require the board, or an investment adviser assignee, to periodically assess and manage material risks associated with fair value determinations, including material conflicts of interest. Outside material conflicts of interest, the Proposed Rule does not identify specific risks a fund board or investment adviser must consider when assessing its valuation risks, nor does it prescribe how frequently a board or investment adviser must perform such assessments. The SEC notes that valuation risks are specific to each fund and that the frequency of risk assessment should account for changes in fund investments, significant changes to investment strategy or policies, and market events, among other things.

Establish and apply fair value methodologies

The Proposed Rule would require the board, or an investment adviser assignee, to consistently select and apply an appropriate methodology or methodologies for determining (including calculating) the fair value of fund investments.

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In doing so, a fund board or investment adviser would be required to identify the key inputs and assumptions specific to each asset class or portfolio holding and the methodologies that will apply to new types of investments contemplated by the fund.

A fund's board or investment adviser would also need to periodically review its valuation methodologies for appropriateness and accuracy, and the board or adviser would need to establish criteria for determining when market quotations are no longer reliable and a determination of fair value is necessary. The SEC also states that valuation methodologies would need to be consistent with ASC Topic 820, which provides guidelines for various valuation approaches including fair value.

Test fair value methodologies

The Proposed Rule would require the board, or an investment adviser assignee, to periodically test the appropriateness and accuracy of the methodologies used to calculate fair value. In addition, the board or investment adviser would be required to identify the testing methods to be used in assessing its valuation methodologies and the minimum frequency such testing methods are used. The Proposed Rule does not prescribe particular testing methods that must be used or the frequency of such tests, with the SEC noting that these determinations are specific to each fund.

Evaluate pricing services

The Proposed Rule would allow funds to use pricing services by third parties that regularly provide funds with pricing information. If a pricing service is used to assist with fair value determination, the fund board or investment adviser would be required to establish a process for approving, monitoring, and evaluating each pricing service provider and the criteria for initiating price challenges. In doing so, a board or investment adviser would be required to consider: (1) the qualifications, experience, and history of the pricing service; (2) the valuation methods or techniques, inputs, and assumptions used by the pricing service for different classes of holdings, and how they are affected as market conditions change; (3) the pricing service's process for considering price challenges, including how the pricing service incorporates information received from pricing challenges into its pricing information; (4) the pricing service's potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and (5) the testing processes used by the pricing service.

Maintain written fair value policies and procedures

Fund boards would be required to adopt and maintain written policies and procedures addressing the determination of the fair value of the fund's investments, and such policies and procedures would need to be reasonably designed to achieve compliance with the requirements of the Proposed Rule. If a board decides to assign fair value determination to an investment adviser, these fair value policies and procedures would need to be adopted and implemented by the adviser subject to board oversight under Rule 38a-1 under the 1940 Act.

Recordkeeping

The Proposed Rule would require funds to maintain supporting documentation of fair value determinations for at least five years from the time the determination was made. For the first two years following a determination, the supporting documentation must be kept in an easily accessible place. Funds must also keep a copy of their policies and procedures in place during the past five years in an easily accessible place.

Assignment to Investment Adviser

Before the Proposed Rule, the SEC had taken the position that a fund board could not delegate its responsibility to determine the fair value of fund assets. Under the Proposed Rule, however, a board would be able to assign this responsibility to an investment adviser, provided that the board continues to supervise and oversee the adviser and the adviser provides regular reports to the board (at least quarterly).

Board oversight

If a fund board assigns fair value determinations to an investment adviser, the Proposed Rule would require the board to oversee the adviser. The Proposed Rule notes that boards should perform their oversight duties “with a skeptical and objective view that takes account of the fund’s particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determination process, and the skill and resources devoted to it.” The Proposed Rule states that such oversight should be active and interactive.

Periodic reporting to the board

Under the Proposed Rule, advisers would be required to report at least quarterly on the adequacy and effectiveness of the adviser’s process for determining fair value. These reports would need to address, at a minimum, material valuation risks, material changes in methodologies, testing results, and the adviser’s oversight of any pricing services used. The reports would also have to discuss the adequacy of resources the adviser allocates to its fair value determination and provide any other materials requested by the fund board related to the adviser’s valuation process.

Under the Proposed Rule, an investment adviser would be required to report any matter that materially affects, or could have materially affected, its valuation of fund assets no later than three business days after it becomes aware of such a matter. Even if an adviser discovers a potential issue and ultimately avoids a material effect, it would be required to report to the fund board if such issue *could have* materially affected its valuation of fund assets.

Specification and segregation of functions

Investment advisers would need to specify in their written policies and procedures the titles of persons responsible for determining fair value and describe the particular functions each person is responsible for. For example, if an adviser has a valuation committee that oversees its fair value determination, the adviser’s policies and procedures should describe the composition and role of the committee or reference any relevant committee governance documents. An adviser’s fair value policies and procedures should also specify the persons and processes for reviewing price challenges and overrides.

The Proposed Rule would also require investment advisers to reasonably segregate the process of making fair value determinations from its portfolio management of the fund in order to avoid potential conflicts of interest. The SEC notes in the proposal that portfolio managers should not make fair value determinations, but acknowledges that their input in the valuation process may be appropriate given their knowledge of a fund’s investments. The SEC also suggests that there should be certain checks on portfolio manager involvement in the determination of fair value, such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel.

“Readily Available” Market Quotations, Defined

Pursuant to Section 2(a)(41)(B) of the 1940 Act, the fund board’s good-faith determination of fair value of a portfolio investment is only required if a market quotation is not otherwise “readily available.” The Proposed Rule defines “readily available” as when a fund can access at its measurement date unadjusted quoted prices in active markets for identical investments, provided that such quotations are “reliable.” A quoted price would be “unreliable” if it would require any adjustment or additional inputs under current U.S. generally accepted accounting principles (GAAP).

Transition Period and Current Fair Value Guidance

The SEC is proposing a one-year transition period for funds, boards, and advisers to come into compliance with the Proposed Rule’s requirements if adopted. After the one-year period, the SEC intends to rescind prior no action letters and other guidance on a fund board’s role in determining fair value.

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