

December 14, 2020

## SEC Adopts New Rule to Modernize Fund Valuation Framework

---

### **New Rule 2a-5 Under the Investment Company Act of 1940 Establishes Requirements for the Determination of Fair Value for Fund Investments, Codifies the Ability of Fund Boards to Designate a Valuation Designee to Perform Fair Valuation Determinations, and Rescinds Certain Existing Guidance**

---

#### **SUMMARY**

On December 3, 2020, the Securities and Exchange Commission (the “SEC” or “Commission”) voted unanimously to adopt new rule 2a-5 (the “Final Rule”) under the Investment Company Act of 1940 (the “Investment Company Act”) to modernize the framework for fund fair valuation practices and permit fund boards to satisfy their fair valuation obligations with respect to registered investment companies and business development companies (“funds”) by designating a valuation designee to perform fair valuation determinations relating to any or all fund investments, subject to the conditions and oversight requirements of the Final Rule.<sup>1</sup>

The Final Rule is largely consistent with the structure of proposed rule 2a-5 (the “Proposed Rule”) in the April 2020 proposing release (the “Proposing Release”).<sup>2</sup> The Commission declined to act on the suggestion of a number of commenters that the rule be restructured as a non-exclusive safe harbor, stating that rule 2a-5 “establishes minimum and baseline standards” and that adopting the rule as a safe harbor “may give the misleading impression that an approach to making fair value determinations that does not meet this minimum baseline would satisfy the board’s statutory obligations.”<sup>3</sup> However, the Final Rule modifies a number of requirements in the Proposed Rule that were considered overly prescriptive and burdensome by many commenters. The Final Rule, among other things:

- ***Provides that a fund board may designate a valuation designee to make fair value determinations.*** The Proposed Rule would have permitted fund boards to “assign” fair valuation determinations to an investment adviser of a fund (including a sub-adviser). The Final Rule abandons the term “assign” (which had been questioned by commenters) and instead provides that a fund board may designate the fund’s investment adviser (other than a sub-adviser) as a “valuation designee” to perform fair value determinations. If the fund does not have an investment adviser (i.e., it is an internally managed fund), the board may designate an officer or officers of the fund as the valuation designee.
- ***Streamlines periodic board reporting requirements.*** In lieu of quarterly assessments of the entire fair value process as required by the Proposed Rule, the Final Rule requires quarterly reports to address issues about which the fund board requests information, as well as information about material changes or events that occurred during the period. On an annual basis, rather than quarterly as in the Proposed Rule, the valuation designee must report its assessment of the adequacy and effectiveness of the valuation designee’s process for determining the fair value of designated investments, testing results and adequacy of allocated resources.
- ***Extends the window for board reporting.*** The Final Rule requires the valuation designee to provide prompt written notification to a fund’s board of matters that materially affect the fair value of the fund’s investments. Such written notification is to be provided no later than five business days after the valuation designee becomes aware of the material matter, extended from the three-business-day window in the Proposed Rule. The valuation designee is not required, however, to complete its materiality assessment within this five-day window where the materiality of a matter is not immediately apparent.
- ***Reaffirms the SEC’s position that evaluated prices are not, by themselves, “readily available” market quotations for purposes of determining whether a security must be fair valued.*** Consistent with the Proposed Rule, the Final Rule 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 the quotation will not be readily available if it is not reliable.
- ***Supersedes prior guidance on thinly traded securities and the use of pricing services.*** In a change from the Proposed Rule, the Final Rule and the Adopting Release supersede guidance on thinly traded securities and the use of pricing services in the adopting release for money market fund reforms in 2014 (“2014 Money Market Fund Release”).<sup>4</sup>
- ***Omits requirement for separate compliance policies and procedures.*** The Final Rule does not include the provision in the Proposed Rule that would have required the fund to adopt separate written policies and procedures reasonably designed to achieve compliance with the requirements of the Final Rule, instead confirming that a fund (or its valuation designee) must adopt and implement fair value policies and procedures reasonably designed to ensure compliance with rules 2a-5 and 31a-4 pursuant to rule 38a-1 of the Investment Company Act (the “Compliance Rule”).

Rather than incorporating recordkeeping requirements into rule 2a-5, the Commission instead adopted new rule 31a-4, which requires a fund or its valuation designee to “maintain appropriate documentation to support fair value determinations.”<sup>5</sup> This change was intended to address concerns of some commenters that failure to maintain the required records could raise doubts about a fund’s compliance with the rule.

The Final Rule represents a significant development with respect to fund fair valuation practices and should generally be well received by fund boards. Many of the requirements of the Final Rule are generally

consistent with fair valuation policies or practices that have been adopted by many fund boards in accordance with longstanding Commission and Commission staff guidance, which have long required active fund board oversight of valuation matters, including receiving reports, evaluating the resources and expertise of a fund's adviser, including the composition of its valuation committee, and monitoring of valuation related conflicts of interest. Nevertheless, fund boards will need to consider carefully their current practices and determine what changes will be required.

This memorandum provides an overview of the Final Rule, which (i) provides requirements for determining fair value in good faith for purposes of section 2(a)(41) of the Investment Company Act, (ii) confirms that a fund's board may make the requisite fair value determinations itself and also permits the board to designate a "valuation designee" to perform fair value determinations, subject to certain conditions and oversight requirements, and (iii) provides that a market quotation with respect to fund investments 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. The memorandum also discusses the related recordkeeping rule and the SEC's rescission of Accounting Series Release ("ASR") 113 and ASR 118<sup>6</sup> as well as certain SEC and SEC staff guidance on related topics.

The Final Rule and new rule 31a-4 will become effective 60 days after the publication of the Adopting Release in the *Federal Register* and will have a compliance date of 18 months following the effective date, upon which ASR 113, ASR 118 and additional identified guidance will be withdrawn. In addition, the SEC has provided funds the option of complying with the new rules prior to the compliance date, allowing fund boards to benefit sooner from the potential for increased compliance certainty provided by the Final Rule.

---

## BACKGROUND

The valuation of a fund's portfolio investments is a critical component of the fund's operations, and affects the fees paid, the returns received and the value of the shares of the fund. Section 22(c) of the Investment Company Act and rule 22c-1 thereunder require registered investment companies that issue redeemable securities to sell and redeem their shares at prices based on the current net asset value ("NAV") of those shares.<sup>7</sup> Rule 2a-4 defines current NAV for use in computing the current price of a redeemable security. Although closed-end funds, including business development companies ("BDCs"), are not subject to rules 2a-4 and 22c-1 under the Investment Company Act, they periodically compute NAV (most publicly traded closed-end funds publish their closing NAV every day while BDCs compute NAV at least quarterly) and the Investment Company Act limits the ability of closed-end funds, including BDCs, to sell shares of their common stock at a price below current NAV.

Pursuant to Section 2(a)(41) of the Investment Company Act and rule 2a-4 thereunder, the board's role in the valuation of a fund's portfolio securities depends on whether market quotations are "readily available."

Where market quotations are readily available, the fund's securities are valued at the current market value of such securities.<sup>8</sup> Where no such market quotations are readily available, a portfolio security value must be fair valued as determined in good faith by the board of directors.<sup>9</sup> Under Section 2(a)(41) of the Investment Company Act, non-security holdings must always be fair valued regardless of whether readily available market quotations exist for such holdings.<sup>10</sup>

In the Adopting Release, the SEC acknowledges that, consistent with longstanding practice, fund investment advisers often play an important and valuable role in carrying out the day-to-day work of determining fair values.<sup>11</sup> However, historically the SEC has never clearly stated that a fund's board is permitted to delegate the responsibility for fair value determinations, and the valuation related SEC and staff guidance has been ambiguous on this point. For example, the SEC has stated that a fund's directors "may not delegate to others the ultimate responsibility of determining the fair value of any asset not having a readily ascertainable market value,"<sup>12</sup> while also stating in ASR 118 that a fund's directors "may appoint persons to assist them in the determination of [fair] value, and to make the actual calculations pursuant to the board's direction."<sup>13</sup> The Commission states in the Adopting Release that under the Final Rule, a fund board remains statutorily responsible for the fair value determinations and can fulfill its continuing statutory obligations itself or, in the case of a designation pursuant to the Final Rule, through active oversight of the valuation designee's performance of fair value determinations and compliance with other requirements of the Final Rule.<sup>14</sup>

The Final Rule was adopted by the SEC in response to the developments in markets and fund investment practices since the Commission last comprehensively addressed valuation 50 years ago, including developments in the accounting and auditing literature, the growing complexity of valuation, and intervening regulatory developments such as the adoption by the Financial Accounting Standards Board of Accounting Standards Codification Topic 820 (Fair Value Measurement) in 2018 and the Compliance Rule's facilitation of board oversight of the fair valuation process.<sup>15</sup>

---

### **SUMMARY OF THE FINAL RULE**

The Final Rule applies to all registered investment companies and BDCs, regardless of their classification or sub-classification (e.g., both open-end funds and closed-end funds), or their investment objectives or strategies (e.g., equity or fixed income; actively managed or tracking an index).<sup>16</sup>

The Final Rule establishes minimum and baseline standards that the Commission believes are inherent in any good faith fair value determination. While the Commission did not recast the Final Rule as a safe harbor, as suggested by a number of commenters, it notes in the Adopting Release that the Final Rule does not establish a single approach to making fair value determinations, and instead establishes a principles-based

framework for boards to use in creating their own specific valuation process, including through designating and appropriately overseeing a valuation designee to perform certain valuation tasks.<sup>17</sup>

### **Fair Value as Determined in Good Faith Under Section 2(a)(41) of the Investment Company Act**

The Final Rule provides that for purposes of Section 2(a)(41) of the Investment Company Act and rule 2a-4 thereunder, determining fair value in good faith with respect to a fund requires:

- **Assessing and Managing Risks.** The Final Rule requires periodically assessing any material risks associated with the determination of the fair value of fund investments, including material conflicts of interest, and managing those identified valuation risks. The relevant risks, and the frequency with which the risks need to be assessed, depend on the facts and circumstances of the particular fund's investments. The Adopting Release reiterates guidance on valuation risks from the Proposing Release, with certain modifications that broaden the examples to include additional sources and types of risk raised by commenters. The Adopting Release includes the following non-exhaustive list of potential sources of valuation risks:
  - (i) The types of investments held or intended to be held by the fund and the characteristics (e.g., the size of the investment relative to measures of market demand, such as daily trading volume) of those investments;
  - (ii) Potential market or sector shocks or dislocations and other types of disruptions that may affect a valuation designee's or a third-party's ability to operate;<sup>18</sup>
  - (iii) The extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the valuation designee;
  - (iv) The proportion of the fund's investments that are fair valued as determined in good faith, and their contribution to the fund's returns;
  - (v) Reliance on service providers that have more limited expertise in relevant asset classes;<sup>19</sup>
  - (vi) The use of fair value methodologies that rely on inputs from third-party service providers, and the extent to which such third-party service providers rely on their own service providers; and
  - (vii) The risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.
- **Fair Value Methodologies.** The Final Rule requires (i) selecting and applying in a consistent manner an appropriate methodology or methodologies for determining (and calculating) 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,<sup>20</sup> (ii) periodically reviewing the appropriateness and accuracy of the methodologies selected and making any necessary changes or adjustments thereto,<sup>21</sup> and (iii) monitoring for circumstances that may necessitate the use of fair value. In response to commenters' concerns about the requirement to select and apply fair value methodologies "in a consistent manner," the Adopting Release clarifies that the 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.<sup>22</sup> In a change from the Proposing Release, the Final Rule does not require the specification of methodologies that will apply to new types of investments in which the fund intends to invest. Finally, although the Final Rule continues to require monitoring for circumstances that may necessitate the use of fair value, it does not require the board (or its

valuation designee) to establish a list of specific criteria for determining when market quotations may no longer be reliable.<sup>23</sup>

Although commenters questioned a statement in the Proposing Release that a methodology used for purposes of determining fair value must be consistent with ASC Topic 820,<sup>24</sup> the Commission reiterated its view that an appropriate methodology must be consistent with those used to prepare a fund's financial statements and thus be consistent with the principles of the valuation approaches laid out in ASC Topic 820.<sup>25</sup> The Commission acknowledges that the valuation approaches laid out in ASC Topic 820 may not directly address every situation that a fund may face because the accounting standards are principles-based.<sup>26</sup>

In response to suggestions from commenters, the Commission also confirmed that certain guidance provided in the 2014 Money Market Fund Release relating to the valuation of thinly traded securities will be superseded by the Final Rule and related guidance in the Adopting Release.<sup>27</sup> Specifically, the Commission states that:

[a]s a general principle, determining fair value requires taking into account market conditions existing at the time of the determination. Accordingly, appropriate methodologies for funds holding debt securities generally should not fair value these securities at par or amortized cost based on the expectation that the funds will hold those securities until maturity, if the funds could not reasonably expect to receive approximately that value upon the measurement date under current market conditions. We continue to believe that fair value cannot be based on what a buyer might pay at some later time, such as when the market ultimately recognizes the security's true value as currently perceived by the portfolio manager. Funds also may not fair value portfolio securities at prices not achievable on a current basis on the belief that the fund would not currently need to sell those securities.<sup>28</sup>

- **Testing of Fair Value Methodologies.** The Final Rule requires the testing of the appropriateness and accuracy of the methodologies used to calculate fair value. Consistent with the requirements discussed above, the specific type and frequency of testing would depend on the facts and circumstances of each fund, but the fund board or valuation designee would need to identify (i) the testing methods to be used, and (ii) the minimum frequency of the testing. The Final Rule does not require particular testing methods or a specific minimum frequency for the testing, which commenters viewed as overly prescriptive.<sup>29</sup> However, the Adopting Release notes that if a specific methodology consistently over-values or under-values one or more fund investments as compared to observed transactions, the board or valuation designee, as applicable, should investigate the reasons for the differences.<sup>30</sup> The Adopting Release also notes the SEC's view that the results of calibration and back-testing can be particularly useful in identifying trends, and also have the potential to assist in identifying issues with methodologies applied by fund service providers, including poor performance or potential conflicts of interest.<sup>31</sup>
- **Pricing Services.**<sup>32</sup> The Adopting Release acknowledges the prevalent use of third-party pricing services, particularly with respect to thinly traded or more complex assets, but continues to note certain conflicts of interest, including that a pricing service might generally provide higher or more aggressive valuations to retain business. Consistent with the Proposed Rule, the Final Rule requires a process for the approval, monitoring and evaluation of each pricing service provider that a fund may use. In a change from the Proposed Rule, the Final Rule requires the establishment of a *process* for initiating price challenges as appropriate, whereas the Proposed Rule would have required funds to establish *criteria* for the circumstances under which price challenges would be initiated.<sup>33</sup>

The Adopting Release includes a list of factors that should be taken into account in deciding to use a pricing service, which the Commission expressly states supersedes its views expressed in the 2014 Money Market Fund Release regarding the use of pricing services. These factors



are generally consistent with those specified in the Proposing Release (except for the addition of item (iii) below):

- (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 classes of holdings, and how they are affected as market conditions change;
  - (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 pricing service's process for considering price "challenges," including how the pricing service incorporates information received from pricing challenges into its pricing information;
  - (v) the pricing service's actual and potential conflicts of interest 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 response to comments, the Final Rule omits the requirement in the Proposed Rule that would have separately required a fund to adopt policies and procedures reasonably designed to achieve compliance with the Final Rule. Instead, the Commission notes that the Compliance Rule by its terms will require the adoption and implementation of written policies and procedures reasonably designed to prevent violations of the requirements of rules 2a-5 and 31a-4.<sup>34</sup> The Adopting Release states that because rules 2a-5 and 31a-4 are new rules under the Investment Company Act with new fair value determination requirements, and given the intrinsic relationship of the rules to the board's own statutory functions relating to valuation, the new fair value policies and procedures must be approved by the board pursuant to rule 38a-1 and are not permitted to be considered material amendments to a fund's existing fair valuation policies and procedures.<sup>35</sup>

### **Performance of Fair Value Determinations**

Recognizing that the resources and expertise required today for determinations of fair value often make it impractical for fund directors to perform necessary valuation tasks without assistance, the Final Rule permits fund boards to designate<sup>36</sup> a "valuation designee," which means the investment adviser, other than a sub-adviser, of a fund, or if the fund does not have an investment adviser, an officer(s) of the fund, to perform the fair value determinations relating to any or all fund investments. This modified approach accommodates internally managed funds that do not have an investment adviser, but the Commission declined otherwise to extend permissible designees beyond the fund's investment adviser, indicating the Commission's belief that it is critical for the entity actually performing the fair value determinations to owe a fiduciary duty to the fund and be subject to direct board oversight whenever possible. With regard to UITs, the Final Rule now permits either the fund's depositor or its trustee to perform the fair value determinations required under rule 2a-5.

The valuation designee will be required to carry out the functions related to good faith determinations of fair value (as summarized above), subject to the additional requirements discussed below.<sup>37</sup> Consistent with the Proposing Release, the SEC made it clear that there is no requirement for fund boards to ratify a

valuation designee's fair value determinations periodically. However, under the Final Rule, the valuation designee is required to make certain reports to the board, specify the titles of the persons responsible for its fair value determinations, and reasonably segregate portfolio management from fair value determinations.

- **Board Oversight.** The Final Rule imposes a general duty of oversight on fund boards<sup>38</sup> and provides guidance that applies to a board's oversight duties specifically in the context of valuation.<sup>39</sup> The Adopting Release states that boards should take 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."<sup>40</sup> The Adopting Release emphasizes that effective oversight cannot be a passive activity, and that fund directors should ask questions and seek relevant information.

The Adopting Release states that fund boards should view oversight as an "iterative" process and "seek to identify potential issues and opportunities to improve the fund's fair value processes."<sup>41</sup> Fund boards are also expected to request follow-up information when appropriate and take reasonable steps to see that matters identified are addressed. The SEC explained, citing guidance in the recent adopting release addressing funds' use of derivatives,<sup>42</sup> that the "use of the word 'iterative' is not intended to imply that the board is responsible for the day-to-day management of the fund's derivatives risk, but is instead intended to clarify that the board's oversight role requires regular engagement with the derivatives risk management program rather than a one-time assessment."<sup>43</sup> In part to ensure that the board has sufficient information to conduct this oversight, the Final Rule requires the valuation designee to report to the board on matters related to the valuation designee's fair valuation process. The Adopting Release notes that fund boards should also request follow-up information when appropriate and take reasonable steps to see that matters identified are addressed.

The Adopting Release further notes that the SEC expects fund boards to use the appropriate level of scrutiny based on each fund's valuation risk, including the extent to which the fair value of the fund's investments depend on subjective inputs. For example, the Adopting Release notes that a board's scrutiny would likely be different if a fund invests in publicly traded foreign companies than if the fund invests in private early-stage companies. As the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, the SEC expects that the board's level of scrutiny would increase correspondingly.

The Commission further states that fund boards, consistent with their obligations under the Investment Company Act and as fiduciaries, should serve as "a meaningful check" on the conflicts of interest of the valuation designee and other service providers involved in the determination of fair values by seeking to identify potential conflicts of interest, monitor such conflicts, and take reasonable steps to manage such conflicts.<sup>44</sup>

Finally, the Adopting Release notes that fund boards should "probe the appropriateness of the valuation designee's fair value processes," and 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, relating to valuation.<sup>45</sup> Furthermore, fund boards should consider the valuation designee's compliance capabilities that support the fund's fair value processes, including the oversight and financial resources available for the fair value process. Boards should also consider the type, content, and frequency of the reports they receive. Although a board can reasonably rely on the information provided to it by the valuation designee and other service providers in conducting its oversight, "it is incumbent on the board to request and review such information as may be necessary to be informed of the adviser's process for determining the fair value of fund investments."<sup>46</sup> If the



board becomes aware of material matters (whether identified by the board itself or the fund's CCO, valuation designee, or another party), the SEC believes that the board's oversight duty requires the board to inquire about such matters and take reasonable steps to see that they are addressed.

- **Board Reporting.** To ensure that fund boards receive tailored and relevant information that will be helpful to their oversight function, the Final Rule requires valuation designees to make both annual and quarterly written reports to fund boards. The reporting requirements in the Final Rule were modified to address commenters' concerns and better match boards' needs and to minimize the chance that boards receive reporting that is too detailed or repetitive to facilitate appropriate oversight.<sup>47</sup> Notably, the Final Rule requires the valuation designee to report its assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of designated investments, testing results and adequacy of allocated resources at least annually rather than quarterly as in the Proposed Rule.

The quarterly reports are required to provide, at a minimum, (1) any reports or materials requested by the board related to the fair value of designated investments or the valuation designee's process for fair valuing fund investments,<sup>48</sup> and (2) a summary or description of material fair value matters that occurred in the prior quarter, including: (i) any material changes in the assessment and management of valuation risks required under rule 2a-5(a)(1), including any material changes in conflicts of interest of the valuation designee (and any other service provider), (ii) any material changes to, or material deviations from, the fair value methodologies established under rule 2a-5(a)(2), and (iii) 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.<sup>49</sup>

The valuation designee's annual report on the adequacy and effectiveness of its process for determining fair values must include, at a minimum (1) a summary of the results of any testing of fair value methodologies required under rule 2a-5(a)(3), and (2) 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.

- **Prompt Board Notification and Reporting.** Under the Final Rule, the valuation designee is required to provide prompt written notification of matters that materially affect the fair value of the fund's investments (e.g., significant deficiencies or material weaknesses in the valuation designee's valuation process) or of material errors in the calculation of net asset value,<sup>50</sup> with such follow-on reporting as the board may determine appropriate. The Final Rule requires such written notification to be provided 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 (extended from the three-business-day window in the Proposed Rule). The Adopting Release notes that some situations may warrant an immediate report. The valuation designee is not required, however, to complete its materiality assessment within this five-day window where the materiality of a matter is not immediately apparent. Where the materiality of a matter is not immediately apparent, if, after 20 business days of becoming aware of the relevant valuation matter, the designee has not been able to determine the matter's materiality, the Commission expects the designee to then notify the board of its ongoing evaluation of the matter within the five-business-day prompt reporting period.<sup>51</sup>
- **Specification of Functions.** The Final Rule requires the valuation designee to specify the titles and particular functions of the individuals responsible for determining the fair value of the assigned investments. To the extent the valuation designee uses a valuation committee or similar body to assist in the valuation, the fair valuation policies and procedures are expected to describe the composition and role of such committee. The valuation designee is also expected to reasonably segregate the process of making fair value determinations from the portfolio management of the fund, in part to avoid potential conflicts of interest.

### **Recordkeeping (Rule 31a-4)**

Rather than incorporating recordkeeping requirements into rule 2a-5, as in the Proposed Rule, the Commission instead adopted new rule 31a-4 under the Investment Company Act, which requires a fund or its valuation designee to maintain appropriate documentation to support fair value determinations.<sup>52</sup> The Adopting Release notes that documentation to support 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.<sup>53</sup> In addition, rule 31a-4 provides that, in cases where the board has designated a valuation designee to perform fair value determinations, the reports and other information provided to the board must include a specified list of the investments or investment types for which the valuation designee has been designated. Under the Final Rule, funds and advisers will generally be required to maintain these records for a total of six years, the first two in an easily accessible place.<sup>54</sup>

### **Readily Available Market Quotations**

The Adopting Release acknowledges that neither the Investment Company Act nor the rules thereunder define when market quotations are "readily available" for the purpose of determining whether a security owned by a fund should be valued based on market quotations or fair value.<sup>55</sup> Consistent with the Proposed Rule, the Final Rule provides that a market quotation is readily available for purposes of Section 2(a)(41) of the Investment Company Act 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 the quotation will not be readily available if it is not reliable.<sup>56</sup> The Adopting Release reaffirms the SEC's position that evaluated prices are not, by themselves, readily available market quotations, and notes that indications of interest and accommodation quotes would not be treated as readily available market quotations under the Final Rule. The Adopting Release notes that the definition of readily available market quotations in the Final Rule will apply in all contexts under the Investment Company Act and the rules thereunder, including rule 17a-7, and indicates that SEC staff is reviewing rule 17a-7 and certain staff letters to determine whether the letters should be withdrawn.<sup>57</sup>

### **Rescission of Prior SEC Releases and Staff Guidance; Proposed Transition Period**

The Final Rule rescinds ASR 113 and ASR 118 in their entirety. The Adopting Release also presents a list of staff letters and guidance (or portions thereof) that are being withdrawn or rescinded in connection with the adoption of rules 2a-5 and 31a-4. As discussed above, the guidance on valuation of thinly traded securities and on pricing services contained in the 2014 Money Market Fund Release will be superseded by the Final Rule and the new guidance in the Adopting Release. In addition, the SEC confirmed that, to the extent any staff guidance not specifically identified in the Adopting Release conflicts with the requirements of the new rules, such guidance will be superseded.<sup>58</sup>

## SULLIVAN & CROMWELL LLP

The Final Rule will become effective 60 days after the publication of the Adopting Release in the *Federal Register* and will have a compliance date of 18 months following the effective date, upon which ASR 113, ASR 118 and additional identified guidance will be withdrawn. In addition, the SEC has provided funds the option of complying with the new rules prior to the compliance date, allowing fund boards to benefit sooner from the potential for increased compliance certainty provided by the Final Rule.<sup>59</sup> A fund that elects to rely on rules 2a-5 and 31a-4 prior to the compliance date may rely only on rules 2a-5 and 31a-4, and not also consider Commission and staff letters and other guidance that will be withdrawn or rescinded on the compliance date in determining fair value in good faith for purposes of section 2(a)(41) and rule 2a-4 thereunder.<sup>60</sup>

\* \* \*

ENDNOTES

- <sup>1</sup> Good Faith Determinations of Fair Value, SEC Release No. IC-34128 (Dec. 3, 2020) (the “Adopting Release”).
- <sup>2</sup> Good Faith Determinations of Fair Value, SEC Release No. IC-33845 (Apr. 21, 2020) (the “Proposing Release”).
- <sup>3</sup> Adopting Release at 11.
- <sup>4</sup> Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014) [79 FR 47736 (Aug. 14, 2014)] (“2014 Money Market Fund Release”).  
For further discussion, see *infra* footnote 27.
- <sup>5</sup> Adopting Release at 80.
- <sup>6</sup> The Commission last comprehensively addressed valuation under the Investment Company Act in a pair of releases issued in 1969 and 1970, Accounting Series Release 113 (“ASR 113”) and Accounting Series Release 118 (“ASR 118”). ASR 113 addressed a number of federal securities law and accounting topics related to the purchase of restricted securities by funds, including how to determine fair value for such securities. ASR 118 expressed the Commission’s views on certain valuation matters, including accounting and auditing, as well as the role of the board in the determination of fair value.  
  
See Securities and Exchange Commission Codification of Financial Reporting Policies, Statement Regarding “Restricted Securities,” Investment Company Act Release No. 5847 (Oct. 21, 1969) [35 FR 19989 (Dec. 31, 1970)], Financial Reporting Codification (CCH) section 404.04 (Apr. 15, 1982) (“ASR 113”); Investment Companies, Investment Company Act Release No. 6295 (Dec. 23, 1970) [35 FR 19986 (Dec. 31, 1970)], Financial Reporting Codification (CCH) section 404.03 (Apr. 15, 1982) (“ASR 118”).
- <sup>7</sup> See, e.g., Section 22(c) of the Investment Company Act and rule 22c-1(a) thereunder. Section 23(c) of the Investment Company Act provides for repurchases of closed-end fund shares. The shares of closed-end funds that are listed on an exchange often trade at a premium or discount to NAV.
- <sup>8</sup> Section 2(a)(41) of the Investment Company Act and rule 2a-4 thereunder.
- <sup>9</sup> *Id.* As used in this memorandum, references to fair value as determined in good faith by the board of directors relate to the fair value of securities where market quotations are not readily available and to fair value of non-security holdings of a fund regardless of whether readily available market quotations exist for that holding.  
  
The Investment Company Act requires fund boards to determine fair value for all fund assets other than securities regardless of the existence of readily available market quotations. However, the Adopting Release notes that application of U.S. GAAP would generally provide for consideration of this information in determining fair value. See Adopting Release at 88, footnote 338.
- <sup>10</sup> See Adopting Release at 87-88.
- <sup>11</sup> See Adopting Release at 8-9.
- <sup>12</sup> Investment Company Act Release No. 13890 (Apr. 16, 1984).
- <sup>13</sup> Investment Company Act Release No. 6295 (ASR 118) (Dec. 23, 1970).
- <sup>14</sup> See Adopting Release at 9.

## ENDNOTES (CONTINUED)

- <sup>15</sup> See Adopting Release at 5. See *also* ASR 113; ASR 118; Proposing Release, footnotes 17-31 and accompanying text (citing to Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, Investment Company Act Release No. 33704 (Nov. 25, 2019); 2014 Money Market Fund Release; Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745.).
- <sup>16</sup> In the case of a unit investment trust ("UIT"), because a UIT does not have a board of directors or investment adviser, a UIT's trustee or UIT's depositor would conduct fair value determinations under the Final Rule. See Adopting Release at 9.
- <sup>17</sup> See Adopting Release at 10-11.
- <sup>18</sup> The Adopting Release includes an additional example, which was not in the Proposing Release: "Additional types of disruptions. . . include, for example, a system failure or cyberattack". See Adopting Release at 16.
- <sup>19</sup> Although a commenter suggested that this factor could deter competition in the market for pricing services, the SEC noted that this factor will not prevent funds from engaging a pricing service with limited experience, but instead will require funds to assess the risks associated with such an engagement and manage them accordingly (for example, through more frequent back-testing of such pricing service's valuation information until it gains more experience). See Adopting Release at 172.
- <sup>20</sup> Regarding the key inputs and assumptions specific to each asset class or portfolio holding, the Adopting Release reiterates that it would not be sufficient, for example, to simply 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). See Adopting Release at 18.
- <sup>21</sup> With regard to periodic review and adjustment, the Adopting Release notes that the results of back-testing or calibration or a change in circumstances specific to an investment could necessitate adjustments to a fund's fair value methodologies. See Adopting Release at 24.
- <sup>22</sup> The Adopting Release acknowledges that there may be circumstances in which it is appropriate to adjust the methodology used if such adjustments would result in a measurement that is equally or more representative of the fair value of the investment. Therefore, the requirement to apply methodologies in a consistent manner would not preclude the board or valuation designee, as appropriate, from changing the methodology where the circumstances of the particular investment call for an adjustment. Accordingly, the consistent application of appropriate methodologies allows for a board or valuation designee, as applicable, to select and apply a different methodology or methodologies for investments in the same asset class, or to change the methodology selected for one or more particular investments, based on changes to the facts and circumstances related to the particular investment if different methodologies are equally or more representative of the fair value of investments. See Adopting Release at 19-20.
- <sup>23</sup> As an example, the Adopting Release notes that if a fund invests in securities that trade in foreign markets, a fund's board or valuation designee generally should identify and monitor for the kinds of significant events that, if they occurred after the market closes in the relevant jurisdiction but before the fund prices its shares, would materially affect the value of the security and therefore may suggest that market quotations are not reliable. See Adopting Release at 25.
- <sup>24</sup> See Adopting Release at 20.
- As the Commission stated in the Proposing Release, ASC Topic 820 refers to valuation approaches and valuation techniques. In practice, many valuation techniques are referred to as *methods* (e.g., discounted cash flow method). As a result, the Adopting Release uses the terms "technique" and

## ENDNOTES (CONTINUED)

- “method” interchangeably to refer to a specific way of determining fair value and likewise uses the terms “methods” and “methodologies” interchangeably. See Adopting Release at 18.
- 25 See Adopting Release at 20-21.
- 26 See Adopting Release at 21.
- 27 See Adopting Release at 22.
- The Commission states that certain guidance from the 2014 Money Market Fund Release will be superseded by guidance in the Adopting Release. Specifically, the last paragraph of Section III.D.2.(a) of the 2014 Money Market Fund Release regarding thinly traded securities will be rescinded. In addition, Section III.D.2.(b) of the 2014 Money Market Fund Release entitled “Use of Pricing Services” will also be rescinded. However, the Commission notes that the guidance in the 2014 Money Market Fund Release on the use of amortized cost valuation remains valid. See Adopting Release at 22, 35, 100.
- 28 Adopting Release at 22-23.
- 29 See Adopting Release at 27.
- 30 See Adopting Release at 28-29.
- 31 As an example, the Adopting Release notes that if a specific methodology consistently over-values or under-values one or more fund investments as compared to observed transactions, the board or adviser should investigate the reasons for this difference. See Adopting Release at 28-29.
- 32 See *supra* footnote 27.
- 33 See Adopting Release at 31-32.
- 34 The Compliance Rule requires a fund’s board to approve the fund’s compliance policies and procedures reasonably designed to prevent violation of the federal securities laws. See rule 38a-1 under the Investment Company Act. Rule 38a-1 also includes a number of additional requirements, such as the appointment by each fund’s board of a chief compliance officer (“CCO”) with responsibility for implementing the fund’s compliance program, and for making an annual report to the fund board.
- 35 The Adopting Release also notes that where the board designates the adviser as valuation designee to perform fair value determinations under the Final Rule, the adviser’s new fair value policies and procedures must be approved by the board pursuant to the Compliance Rule and likewise are not permitted to be considered material amendments to the adviser’s existing fair value policies and procedures. Under this approach, the board can fulfill its responsibilities under the Compliance Rule if the adviser adopts fair value policies and procedures that the board approves (without the need for the fund to adopt duplicative policies separately). Still, fund boards must approve the adviser’s fair value policies and procedures, as such changes cannot be reported to the board by the fund’s CCO as material amendments. See Adopting Release at 38-39.
- 36 The Final Rule provides that the board may “designate” the performance of these fair value determinations to a valuation designee. However, the Commission notes that this change was made in response to commenters who claimed that the scope of the language in the Proposing Release (which provided that the board may “assign” such task) was unclear. After considering comments, the Commission determined that a board “designating” a valuation designee better describes the relationship between the board and the valuation designee under the Final Rule, namely, where the valuation designee performs the fair value determinations for the fund subject to appropriate oversight by the fund’s board. See Adopting Release at 41.
- 37 Notwithstanding the focus on the role of the valuation designee, a fund board may still choose to make its own good-faith determinations of fair value. In such a case, the fund board would not be subject to the requirements associated with a designation of fair value determinations to the



## ENDNOTES (CONTINUED)

- valuation designee, but would still need to adopt and implement policies and procedures under the Compliance Rule to address valuation issues and keep records consistent with the requirements of the rules. See Adopting Release at 40, footnote 134.
- 38 As in the Proposing Release, the Final Rule defines “board” as both the full board or a designated committee thereof composed of a majority of directors who are not interested persons of the fund. See Adopting Release at 49.
- The Commission notes that whether the board or the valuation designee makes fair value determinations under the Final Rule, it may obtain assistance from others, such as pricing services, fund administrators, sub-advisers, accountants, or counsel in fulfilling its duties. That assistance can take different forms such as performing back-testing as specified by the valuation designee and performing calculations required by the valuation method selected by the board or valuation designee. The board or the valuation designee, using this assistance, remains responsible for the fair value determination and may not designate or assign that responsibility to the third party, and must still perform its responsibilities under the Investment Company Act, the Final Rule, and other applicable rules. See Adopting Release at 49-50.
- 39 The Commission believes that specific guidance with respect to board oversight in the context of making fair value determinations is appropriate because Section 2(a)(41) is one of the few provisions of the Investment Company Act that specifically imposes a requirement on fund boards, requiring boards to determine fair value in good faith. Therefore, it is the Commission’s view that a board may satisfy its statutory obligation to determine fair value even though it has designated another entity to perform fair value determinations under the Final Rule, subject to appropriate oversight. See Adopting Release at 52.
- 40 Adopting Release at 55.
- 41 Adopting Release at 56.
- 42 See Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 34078 (Oct. 29, 2020).
- 43 See Adopting Release at 56, footnote 210.
- See also *infra* footnote 46.
- 44 In overseeing the valuation designee’s process for making fair value determinations, the board should understand the role of, and inquire about conflicts of interest regarding, any other service providers used by the valuation designee as part of the process, and satisfy itself that any conflicts are being appropriately managed. See Adopting Release at 57.
- 45 See Adopting Release at 58.
- 46 In the Proposing Release, the SEC characterized the board’s role as requiring that it be “fully informed” of the adviser’s process. However, in response to commenters, the Adopting Release has clarified that the intent was *not* to imply that the board should be actively managing the process, but rather to make sure that the board is thoughtful, seeks additional information when needed, and does not solely rely upon information provided to it by the valuation designee. See Adopting Release at 58.
- 47 See Adopting Release at 60-61.
- 48 The Final Rule does not require the production of any particular data or analytical tools, such as trend dashboards, unless the board requests them. See Adopting Release at 68.
- 49 In the Proposing Release, the Commission set forth a non-exhaustive list of specific items that a board may consider reviewing in conducting its oversight. However, as a result of commenters objections, the Adopting Release clarifies and confirms that these are not mandatory. See Adopting Release at 68.

## ENDNOTES (CONTINUED)

- 50 Some commenters had suggested that the Commission set an NAV error threshold, similar to that generally utilized in the industry at \$0.01 a share or 0.5% of the NAV, as the threshold for prompt reporting. While declining to establish that specific standard as what constitutes a “material error in the calculation of net asset value” for purposes of the Final Rule, the Commission agreed that relying upon that standard would not be unreasonable. See Adopting Release at 72.
- 51 The Commission notes that a valuation designee should act promptly in seeking to determine the materiality of a matter, and not take the 20 business days as a matter of course, in order to enable the board to provide effective oversight. See Adopting Release at 74.
- 52 The SEC notes in the Adopting Release that the requirement to maintain appropriate documentation to support fair value determinations should include documentation that would be sufficient for a third party, such as the Commission’s staff, not involved in the preparation of the fair value determinations to verify, but not fully recreate, the fair value determination. Examples of the types of records that the SEC considers to be “appropriate documentation to support fair value determinations” include records that valuation designees currently create in the ordinary course of performing fair value determinations and working papers currently produced by advisory personnel supporting fair value determinations that include, for example, copies of internally developed valuation models, including inputs and assumptions used therein and relevant supporting documentation. See Adopting Release at 84.
- 53 See Adopting Release at 84.
- 54 See Adopting Release at 87.
- 55 As noted above, non-security holdings must always be fair valued regardless of whether readily available market quotations exist for that holding. The Investment Company Act requires boards to determine fair value for all assets other than securities regardless of the existence of readily available market quotations. However, the Adopting Release notes that application of U.S. GAAP would generally provide for consideration of this information in determining fair value. See Adopting Release at 88, footnote 338.
- 56 See Adopting Release at 87-88.
- 57 In response to concerns raised by a number of commenters, the SEC acknowledged that many cross trades today are done taking into consideration certain letters by the SEC staff that address, among other things, the application of the term readily available market quotations in the context of certain transactions under rule 17a-7. The Adopting Release states that the SEC staff is reviewing these letters to determine whether these letters, or portions thereof, should be withdrawn. Separately, consideration of potential revisions to rule 17a-7 is on the SEC’s rulemaking agenda. See Adopting Release at 93-94.
- 58 See Adopting Release at 99-100.
- 59 See Adopting Release at 101.
- 60 See Adopting Release at 101.

## SULLIVAN & CROMWELL LLP

### ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

### CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to [SCPublications@sullcrom.com](mailto:SCPublications@sullcrom.com).