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# *SEC Adopts Modernized Framework for Fund Valuation Practices*

By Investment Management Practice

On Thursday, December 3, 2020, the Securities and Exchange Commission (the "SEC" or the "Commission") adopted new rule 17 CRF 270.2a-5 (the "Final Rule")[1] that sets forth an updated regulatory framework for fund valuation practices under the Investment Company Act of 1940, as amended (the "1940 Act" or the "Act").[2] The Final Rule was first proposed in April 2020 (the "Proposed Rule") and the SEC, after considering comments, adopted the Final Rule with certain modifications from the Proposed Rule to address some of the comments submitted by industry participants. The Final Rule: (1) establishes requirements for determining fair value in good faith of a fund's investments for purposes of section 2(a)(41) of the Act and rule 2a-4 thereunder; (2) permits boards, subject to oversight and other conditions, to designate certain parties to perform fair value determinations; and (3) defines "readily available" market quotations for purposes of section 2(a)(41) of the 1940 Act.[3] The Final Rule extends to all registered investment companies and business development companies ("BDCs"), regardless of their classification or investment objectives or strategies.

### Final Rule: Key Takeaways

The Final Rule is a result of the Commission's response to developments in markets and fund investment practices since the Commission last comprehensively addressed fund valuation 50 years ago.[4] In a statement, the SEC's Chairman Clayton noted that "investors… rely on [funds] to value their investments properly" and that the Final Rule is "designed to improve funds' valuation practices, including by providing for effective board oversight, for the benefit and protection of fund investors."[5]

The following are some of the key takeaways from the Final Rule:

- ***Fair Value as Determined in Good Faith****.* As in the Proposed Rule, the Final Rule states that fair value as determined in good faith requires (1) assessing and managing material risks associated with fair value determinations, including material conflicts of interest; (2) selecting, applying, and testing fair value methodologies; and (3) overseeing and evaluating any pricing services used.[6]

- ***Who Performs Fair Value Determinations***? The Final Rule will permit a fund's board to designate a "valuation designee" to perform fair value determinations, whether an investment adviser of the fund, or in a change from the Proposed Rule, an officer of an internally managed fund, subject to board oversight.[7] In the adopting release dated December 3, 2020 (the "Adopting Release"), the Commission noted that under the Final Rule, the board remains responsible for the fair value determinations required by the statute and further noted that "[w]here the board designates a valuation designee to perform fair value determinations under the final rule, the board will fulfill its continuing statutory obligations through active oversight of the valuation designee's performance of fair value determinations and compliance with the other requirements of the final rule."[8]

- ***Recordkeeping***. The Commission also adopted new rule 31a-4 under the 1940 Act. This rule will require funds or their advisers, as applicable, to maintain appropriate documentation to support fair value determinations and, where applicable, documentation related to the designation of the valuation designee.

- ***Readily Available Market Quotation****.* The definition of readily available market quotation was adopted as proposed. Under section 2(a)(41) of the 1940 Act, fund investments must be fair valued where market quotations are not "readily available." The Final Rule provides that a market quotation is "readily available" when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date. However, the Commission noted that a market quotation would not be readily available if it is not reliable. The Adopting Release noted that this definition is consistent with the definition of a level 1 input in the fair value hierarchy outlined in U.S. GAAP. Under the Final Rule, "evaluated prices," "indications of interest," and "accommodation quotes" would not be "readily available" market quotations.[9] In addition, with respect to cross-trades conducted pursuant to rule 17a-7 under the 1940 Act, the Commission noted that the definition of readily available market quotations would apply in all contexts under the 1940 Act and the rules thereunder, including rule 17a-7.

- ***Rescission of Prior Commission Releases and Guidance****.* As proposed, the Adopting Release notes that ASR 113 and ASR 118 are being rescinded in their entirety. The Commission noted that rescission is appropriate because the guidance included in ASR 113 and ASR 118 is superseded or made redundant by the adoption of rule 2a-5 and by the requirements under the current accounting and auditing standards. In addition to the Commission's rescission of ASR 113 and ASR 118, certain Commission guidance, staff letters, and other staff guidance addressing a board's determination of fair value and other matters covered by the rules will be withdrawn or rescinded in connection with the adoption of the Final Rule.

## Determination of Fair Value

The Final Rule sets forth certain required functions that must be performed to determine the fair value of the fund's investments in good faith. The required functions are:

1. *Periodically Assess and Manage Valuation Risks* – The Final Rule (as in the Proposed Rule) requires periodic assessment of any material risks associated with fair valuing investments, including material conflicts of interest, and managing identified valuation risks. Also, as in the Proposed Rule, the Final Rule does not identify other specific valuation risks that may need to be addressed under this requirement or establish a specific re-assessment frequency.
2. Similar to the Proposed Rule, the Final Rule reiterates the non-exhaustive list of sources and types of valuation risks, with several modifications, including:
    - the types of investments held or intended to be held by a fund, and the characteristics of those investments;

- Potential market or sector shocks or dislocations and other types of disruptions that may affect a valuation designee or a third-party's ability to operate;

- the extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the valuation designee;

- the proportion of a fund's investments that are fair valued as determined in good faith and their contribution 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 third-party service providers rely on their own service providers (so-called "fourth-party" risks); and

- the risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.

The Commission noted in the Adopting Release that the Final Rule, like the Proposed Rule, is designed to provide a board or valuation designee, as applicable, with the flexibility to determine which of the identified sources and types of valuation risk are relevant to the fund's investments, as well as to identify other risks not listed above.

3. *Establish and Apply Fair Value Methodologies* – The Final Rule provides that fair value, as determined in good faith, requires the board or valuation designee, as applicable, to establish and apply fair value methodologies. To satisfy this requirement, a board or valuation designee, as applicable, must:

   - Select and apply appropriate fair value methodologies.

     - This requirement has been modified from the Proposed Rule in two ways: (1) the Final Rule provides that the selected methodologies for fund investments may be changed, if different methodologies are equally or more representative of the fair value of the investment and (2) the Final Rule will not require the specification of methodologies that will apply to new types of investments in which the fund intends to invest;

     - In addition, the Commission noted that guidance contained in this section addresses the same concerns discussed in the guidance contained in the last paragraph of the section on valuing thinly traded securities in the 2014 Money Market Funds Adopting Release. As a result, the paragraph in the 2014 Money Market Funds Adopting Release is superseded and, the Adopting Release further noted that "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."

   - Periodically review the appropriateness and accuracy of the methodologies selected and make any necessary changes or adjustments thereto.

   - Monitor for circumstances that may necessitate the use of fair value.

– In a change from the Proposing Release, the Final Rule will not require a list of specific criteria for determining when market quotations may no longer be reliable because such a requirement "could limit the board's or valuation designee's flexibility to consider the full range of conditions that may affect the reliability of market quotations."

Under the Final Rule, as under the Proposed Rule, and in accordance with current accounting standards, a methodology used for purposes of determining fair value must be consistent with ASC Topic 820, and thus, derived from one of the approaches outlined in ASC Topic 820. However, the SEC acknowledged that there is no single methodology for determining the fair value of an investment "because fair value depends on the facts and circumstance of each investment, including the relevant market and market participants."

4. *Testing of Fair Value Methodologies* – The Final Rule requires the testing of the appropriateness and accuracy of the methodologies used to calculate fair value by identifying:

- the testing method for valuation to be used; and
- the minimum frequency of that testing.

The Adopting Release notes that "calibration" and "back-testing" are useful tools to identify trends in certain circumstances and can assist in identifying issues with methodologies applied by fund services providers.[10] However, the Final Rule does not require calibration and back-testing, nor does it preclude boards or valuation designees, where applicable, from using other appropriate testing methods.[11]

5. *Pricing Services* – As in the Proposed Rule, the Final Rule provides that determining fair value in good faith requires the oversight and evaluation of pricing services, when used. For funds using pricing services, the Final Rule requires that the board or valuation designee, as applicable, establish a process for approving, monitoring, and evaluating each service provider. The Final Rule also requires that the board or valuation designee, as applicable, establish a process for initiating price challenges, as appropriate. In a change from the Proposed Rule, the Final Rule requires funds to establish a process for initiating price challenges, as appropriate (as opposed to the proposed approach which would have required funds to establish criteria for the circumstances under which price challenges would be initiated). Under the Final Rule, a board or valuation designee, as applicable, prior to deciding on the use of a pricing service, should consider factors such as:

- the qualifications, experience, and history of the pricing service;
- the valuation methods or techniques, inputs, and assumptions used by the pricing service for different classes of holdings, and how they are affected (if at all) as market conditions change;
- 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;
- the pricing service's process for considering price challenges, including how the pricing service incorporates information received from price challenges into its pricing information;
- the pricing service's potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts;
- the testing processes used by the pricing service.[12]

The Commission noted that it believes that pricing services may have conflicts of interest, such as maintaining continuing business relationships with the valuation designee. Therefore, given the widespread reliance on pricing services, the critical role they play in the valuation of fund investments, and their potential conflicts of interests, regardless of whether they are affiliated with the fund's adviser, the Final Rule will require that pricing services be subject to oversight so that the board or valuation designee, as applicable, has a reasonable basis to use the pricing information it receives as an input in determining fair value in good faith.[13]

6. *Fair Value Policies and Procedures* – The Final Rule does not include the provision in the Proposed Rule that would have required a fund to adopt written policies and procedures designed to achieve compliance with the requirements of rule 2a-5. Instead, when the board determines the fair value of investments, the fund will adopt and implement the fair value policies and procedures under the compliance rule 38a-1.[14]

### Performance of Fair Value Determinations

Largely as proposed, under the Final Rule, a board may choose to determine fair value in good faith for any or all fund investments by carrying out all of the functions required in paragraph (a) of the Final Rule, including selecting and applying valuation methodologies. A board could also designate the performance of fair value determinations relating to any or all fund investments to a valuation designee, subject to board oversight.

The Final Rule requires the valuation designee make certain reports to the board, specify responsibilities regarding fair value determinations, and reasonably segregate portfolio management from fair value determinations.[15] The trustee or depositor will generally perform the fair value functions for UITs, which do not have a board or adviser. These provisions are designed to provide boards, valuation designees, or other parties involved with a consistent approach to the allocation of fair value functions that recognizes the important role that valuation designees can play in the fair value process, while also preserving a role for boards to fulfill their obligations under section 2(a)(41) of the 1940 Act by meeting the requirements of the Final Rule.

1. *Designate or Assign*

The Final Rule provides that a board may "designate" the performance of fair valuation determinations to a valuation designee. This is a change from the Proposed Rule which would have provided that the board may "assign" such task to an adviser.

2. *Who May Be Designated*

Under the Final Rule, a board may designate a fund's adviser to perform fair value determinations, or, if the fund is internally managed, an officer of the fund. The Adopting Release notes that the SEC declined to expand permissible designees beyond the adviser, or officer of the fund (although not a portfolio manager of the fund), as applicable, because "it is critical for the entity actually performing the fair value determination to owe a fiduciary duty to the fund and be subject to direct board oversight whenever possible." For the purposes of the Final Rule, where the valuation designee is an adviser, it must be an adviser of the fund, not another service provider, regardless of whether or not they are registered as advisers or acting under a contract with the fund. Likewise, in a change from the Proposed Rule, the Final Rule will not permit boards to designate the performance of fair value determinations to fund sub-advisers. However, boards or their valuation designee will be permitted to seek the assistance of sub-advisers as they see appropriate.

In the case of UITs, the Final Rule expands on the Proposed Rule, and allows for either the UIT's depositor or trustee to perform the fair value determinations required. Also, to the extent that the assistance of other parties, such as evaluators, is necessary, trustees or depositors may seek their assistance.[16] Further, existing UITs will be grandfathered under limited circumstances, if the initial deposit of securities in the UIT took place prior to the effective date of the Final Rule, to the extent that another entity other than the trustee or depositor had been designated in the trust indenture to perform fair value determinations, the previously designated entity may perform such fair valuations pursuant to the Final Rule.[17]

The Final Rule, in a simplification of the requirements in the Proposed Rule, will require the valuation designee to make both annual and quarterly written reports to the board. In addition, the Final Rule requires that the valuation designee provide a written notification of the occurrence of matters that materially affect the fair value of the designated portfolio investments within a time period determined by the board, but no less than five business days (the Proposed Rule would have required three business days) after the valuation designee becomes aware of such material matter.[18] The valuation designee must also provide timely follow-up reports as the board reasonably determines are appropriate.

3. *Obtaining the Assistance of Others*

Whether the board or the valuation designee makes fair value determinations under the Final Rule, it may obtain assistance from others in fulfilling its duties. That assistance can take different forms, such as fund administrators, pricing services, sub-advisers, accountants, and counsel, and may consist of services, such as performing back-testing and performing calculations required by the selected valuation method.[19]

4. *Board Oversight*

As in the Proposed Rule, the Final Rule requires that where a board designates fair value determinations to a valuation designee, the board must satisfy its statutory obligation with respect to such determinations by overseeing the valuation designee. The Adopting Release notes that effective oversight cannot be a passive activity and fund directors should ask questions and seek relevant information. In addition, oversight should be an iterative process and seek to identify potential issues and opportunities to improve the fund's fair value processes. The Adopting Release does acknowledge that the level of board oversight will vary by fund.

Boards would also be required to take reasonable steps to manage conflicts of interest associated with an adviser's fair value determinations. The Adopting Release notes that a board should serve as a meaningful check on the conflicts of interest of the adviser and other service providers involved in the determination of fair values. Specifically, a fund's adviser may have an incentive to improperly value fund assets in order to increase fees, improve or smooth reported returns, or comply with the fund's investment policies and restrictions. Other service providers, such as pricing services or broker-dealers providing opinions on prices, may have incentives (such as maintaining continuing business relationships with the valuation designee) or may otherwise be subject to pressure to provide pricing estimates that are favorable to the valuation designee.[20]

## Recordkeeping

The Commission also adopted new rule 31a-4. Rule 31a-4 will require, substantially as proposed, funds or their advisers to maintain appropriate documentation to support fair value determinations.

Rule 31a-4 provides that, in cases where the board has designated the performance of fair value determinations to a valuation designee, 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. In a change from the Proposed Rule, these records will generally be required to be maintained for six years (instead of the proposed five years), the first two in an easily accessible place. In an additional change from the proposal, rule 31a-4 will require funds or their advisers to maintain appropriate documentation to support fair value determinations, rather than requiring a fund or adviser to keep records of the specific methodologies applied, and assumptions and inputs that form the basis of the fair value determination in all cases. Lastly, as proposed, funds will be required to maintain these records, unless the board has designated the performance of fair value determinations to the fund's adviser. In that case, the adviser will maintain the records.

In a change from the Proposed Rule, the Commission is not requiring detailed records relating to the specific methodologies a pricing service applied, and the assumptions and inputs a pricing service considered when providing each piece of pricing information. Rather, appropriate documentation to support a 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 is appropriate.

## Readily Available Market Quotations

The Final Rule provides that a market quotation is readily available for purposes of section 2(a)(41) of the 1940 Act with respect to an investment only when that "quotation is a quoted price (unadjusted) in active markets for identical investments that a fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable." Under the Final Rule, as under the Proposed Rule, a quote would be considered unreliable in the same circumstances where it would require adjustment under U.S. GAAP or where U.S. GAAP would require consideration of additional inputs in determining the value of the security.

For example, the Adopting Release notes that under the Final Rule, funds would, consistent with U.S. GAAP, use previous closing prices for securities that principally trade on a closed foreign market to calculate the value of that security, except when an event has occurred since the time the value was established that is likely to have resulted in a change in such value. In such circumstances, a fund would need to fair value the security. The Adopting Release specifically disagreed with certain commenters and noted that such adjustments would be necessary in order to be consistent with ASC Topic 820-10-35-36B and 35-41C. With respect to valuation of private fund securities, the Commission noted that "these securities generally do not have readily available market quotations under the final definition because their value is not based on unadjusted quoted prices."

### *Cross Trades*

In the Adopting Release, the Commission acknowledged that a number of commenters raised concerns that the proposed definition of readily available market quotations may affect current practices on cross trades under rule 17a-7. Nonetheless, the Commission noted that the adopted definition of readily available market quotations would apply in all contexts under the 1940 Act and the rules thereunder, including rule 17a-7.

As a result, certain securities that had been previously viewed as having a readily available market quotation and being available to cross trade under rule 17a-7 may not meet the Commission's new definition and thus, would not be available for such trades. For example, the Adopting Release notes that level 2 inputs under the U.S. GAAP hierarchy are not consistent with the concept of readily available market quotations under the 1940 Act and as a result, the Commission believes that securities valued with level 2 inputs are not consistent with the definition of readily available market quotations.

Furthermore, the SEC staff noted in the Adopting Release that there are many cross trades that 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 notes that the Commission is reviewing those letters to determine whether the letters, or portions thereof, should be withdrawn. Separately, the Commission is considering potential revisions to rule 17a-7.

### Rescission of Prior Commission Releases

As proposed, the Commission is rescinding two previous releases on fund valuation, Accounting, Series Release 113 (ASR 113) and Accounting Series Release 118 (ASR 118), which the Commission states is appropriate because the guidance included therein is superseded or made redundant by the adoption of the Final Rule.

The Commission disagreed with certain commenters that certain fund specific valuation issues are not addressed in U.S. GAAP. Instead, the Commission continues to believe that the principles in ASC Topic 820 provide a framework appropriate to utilize for all fair value measurements. As a result, the Adopting Release notes that "the specific incremental guidance included in the ASRs is no longer necessary."

Additionally, the Adopting Release addresses that certain staff letters and staff guidance may be rescinded in connection with the Final Rule.

### Proposed Transition Period

The Commission is adopting an 18-month transition period (an extension of the proposed one-year period) for funds to prepare for compliance with the Final Rule. This transition period will begin 60 days after publication of the Final Rule in the Federal Register.

The Final Rule is available at https://www.sec.gov/rules/final/2020/ic-34128.pdf.

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*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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[1] Good Faith Determinations of Fair Value, SEC Release Nos. IC-34128; File No. S7-07-20, https://www.sec.gov/rules/final/2020/ic-34128.pdf (December 3, 2020) (the "Adopting Release").

[2] SEC Proposes to Modernize Framework for Fund Valuation Practices, SEC, available at https://www.sec.gov/news/press-release/2020-93 (April 21, 2020) (the "Proposing Release").

[3] Adopting Release at 1.

[4] Id. at 5.

[5] Press Release, SEC Modernizes Framework for Fund Valuation Practices (Dec. 3, 2020).

[6] Adopting Release at 8.

[7] Id. at 8.

[8] Id. at 9.

[9] Id. at 87.

[10] Id. at 28 n.89. (The Adopting Release defines "calibration" as the process for monitoring and evaluating whether there are material differences between the actual price the fund paid to acquire portfolio holdings that received a fair value under the Act and the prices calculated for those holdings by the fund's fair value methodology at the time of acquisition).

[11] Id. at 29.

[12] Id. at 35-36.

[13] Global Securities Pricing Service to Pay $8 Million for Compliance Failures, SEC Release No. 5643, File No. 3-20164, https://www.sec.gov/news/press-release/2020-310. (Dec. 9, 2020) (In the ICE enforcement action, the Commission alleged that the pricing service delivered to its clients prices based on single broker quotes, while failing to adopt and implement policies and procedures reasonably designed to address the risk that these prices would not reasonably reflect the value of the securities. The order further finds that the company's quality controls for prices based on single broker quotes were not effectively or consistently implemented.)

[14] Id. at 37-39; 37 n.126. (Rule 38a-1 requires a fund's board, including a majority of its independent directors, to approve the fund's policies and procedures, and those of each adviser and other specified service providers, based upon a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal securities laws.)

[15] Id. at 40.

[16] Id. at 47.

[17] Id. at 48.

[18] Id. at 69. (Material matters in this instance include, as examples, a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process or of material errors in the calculation of net asset value.)

[19] Id. at 51.

[20] Id. at 56-57.