



Investment Management Update

December 2020

SEC Modernizes Framework for Fund Valuation Practices

Key Notes:

- Rule 2a-5 establishes a framework for determining fair value in good faith.
- Boards may designate a valuation designee to perform fair value determinations, subject to board oversight.
- Funds will be required to establish a process to approve, monitor and evaluate pricing service providers.

On December 3, 2020, the Securities and Exchange Commission (the “Commission”) adopted Rule 2a-5 (the “Rule”) under the Investment Company Act of 1940 (the “Act”) in order to provide a framework for fund valuation practices. The Rule establishes requirements for determining fair value and permits boards to designate certain parties to perform the fair value determinations subject to board oversight and certain other conditions. In connection with the Rule’s adoption, the Commission rescinded previously issued guidance on related issues, including the role of the board of directors in determining fair value and the accounting and auditing of fund investments.

Performance of Fair Value Determinations

Under the Rule, a board may choose to determine the fair value for fund investments, including selecting and applying valuation methodologies. The Rule also allows a board to delegate such responsibilities to a valuation designee, subject to board oversight. In a change from the proposal, which would have permitted boards to assign only to an adviser of the fund, the Rule permits boards to designate the fund’s adviser to perform fair value determinations. The

final rule also clarifies that the valuation designee can engage third parties to assist with certain functions of the fair value determination process, such as performing back-testing, fund accounting, or shareholder reporting.

Board Oversight

In fulfilling their oversight responsibility, the Commission emphasized that boards have a duty to identify, monitor, and manage potential conflicts of interest with respect to the adviser or other service providers involved in a fair value determination. The Rule directs boards to approach their oversight of performance of the fair value determinations with a “skeptical and objective view,” which includes a periodic review of the fund’s particular valuation risks, including with respect to conflicts, the appropriateness of the fair value process and the skills and resources devoted to it.

The valuation designee must specify the titles of the persons responsible for fair valuing the assigned investments, including the functions for which they are responsible. Moreover, the specific personnel with responsibilities associated with price challenges should be identified, including those with the authority to override a price. The valuation designee must also reasonably segregate fair value determinations from the portfolio management of the fund. The adopting release (“Release”) explains that portfolio managers are not prohibited from participating in the fair value process as they often are the most knowledgeable regarding the fund’s investments. Instead, the Commission clarified that the portfolio manager “may not determine, or effectively determine by

exerting substantial influence on, the fair values ultimately ascribed to portfolio investments.” The segregation process should be appropriately rigorous and robust to mitigate any potential conflicts of interest.

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

The Rule sets forth certain functions that must be performed to determine the fair value of the fund’s investments including the periodic assessment and management of valuation risks, establishment and application of fair value methodologies, testing of fair value methodologies for appropriateness and accuracy, requirements for the use of pricing services, and the adoption of written compliance policies and procedures. Each of these functions are discussed below.

Periodically Assess and Manage Valuation Risks

The Rule requires the periodic assessment of any material risks associated with the determination of the fair value of a fund’s investments, including material conflicts of interest, and to manage those identified valuation risks. However, the Rule does not identify other specific valuation risks that may need to be addressed or establish a specific re-assessment frequency. In the Release, the Commission stated that the periodic reassessment of valuation risk generally should take into account changes in fund investments, significant changes in investment strategy or policies, market events and other relevant factors.

Additionally, the Rule’s Release provides a non-exhaustive list of examples of sources or types of valuation risk. The Commission reiterated that the risks identified are not intended to be a comprehensive list of all possible sources of valuation risk, but instead, a set of examples that may help inform fund boards and valuation designees. The list of sources or types of valuation risk include:

- The types of investments held or intended to be held by the 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’s 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 the 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.

Establish and Apply Fair Value Methodologies

The Rule requires 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 must: (1) select and apply appropriate fair value methodologies; (2) periodically review the appropriateness and accuracy of the methodologies selected and make any necessary changes or adjustments thereto; and (3) monitor for circumstances that may necessitate the use of fair value.

Select and Apply Appropriate Fair Value Methodologies

The Rule requires the board or valuation designee to select and apply in a consistent manner an appropriate methodology or methodologies for determining and calculating the fair value of fund investments. A board or valuation designee will have to specify the key inputs and assumptions specific to each asset class or portfolio holding. The 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 investments and will not require the specification of methodologies that will apply to new types of investments in which the fund intends to invest.

Periodically Review the Appropriateness and Accuracy of the Methodologies Selected

To establish and apply fair value methodologies appropriately, the Rule requires a board or valuation designee to periodically review the selected fair value methodologies for appropriateness and accuracy, and to make changes or adjustments to the methodologies where necessary.

Monitor for Circumstances That May Necessitate the Use of Fair Value

The Rule requires a board or valuation designee to monitor for circumstances that may necessitate the use of fair value as determined in good faith. For example, if a fund invests in securities that trade in foreign markets, the 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.

Test Fair Value Methodologies for Appropriateness and Accuracy

The Rule requires the board or valuation designee to identify the testing methods to be used and the minimum frequency with which such testing methods are used but does not require particular testing methods or a specific minimum frequency for the testing. In the Release, the Commission reiterated that the specific tests to be performed and the frequency with which such tests should be performed are matters that depend on the circumstances of each fund and thus should be determined by the board or the valuation designee.

Pricing Services

The Rule provides that determining fair value in good faith requires the oversight and evaluation of pricing services. For funds that use pricing services, the Rule requires that the board or valuation designee establish a process for approving, monitoring, and evaluating each pricing service provider. The Rule requires that the board or valuation

designee establish a process for initiating price challenges as appropriate. Under the Rule, before deciding to use a pricing service, the fund's board or valuation designee should generally take into consideration 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 actual and potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and
- the testing processes used by the pricing service.

In addition, the fund's board or valuation designee should generally consider the appropriateness of using pricing information provided by a pricing service in determining the fair values of the fund's investments where, for example, the fund's board or valuation designee does not have a good faith basis for believing that the pricing service's pricing methodologies produce prices that reflect fair value.

Fair Value Policies and Procedures

The Rule does not include the provision in the proposed rule that would have separately required a fund to adopt written policies and procedures reasonably designed to achieve compliance with the Rule. The Rule, by its terms, will require the adoption and implementation of written policies and procedures reasonably designed to prevent violations of the requirements of the Rule and the Recordkeeping Rule. Accordingly, the Rule does not include a separate policies and procedures requirement.

Reporting

To facilitate oversight, the rule establishes new reporting requirements. A board must evaluate the type, content, and frequency of such reports and request any additional information necessary to be fully informed of the valuation designee's process for determining fair value of fund investments. It is the Commission's view that reporting requirements are "intended to assist boards in their oversight responsibility under the Rule and to ensure that boards receive the amount and type of information to oversee the valuation designee." The Rule explains that these are minimum reporting requirements and boards may find that additional information is necessary and appropriate in order to discharge their oversight responsibilities accordingly.

Periodic Reporting

At least quarterly, the valuation designee must provide a board with a report regarding management of the valuation process. At minimum, this report must summarize the following:

- The assessment and management of material valuation risks, including conflicts of interest attendant to the valuation designee and any other service provider;
- Material changes to, or deviations from, established fair valuation methodologies;
- Material changes to the adviser's process for overseeing pricing services and material events, such as changes to service providers or price overrides; and
- Any other materials requested by a board.

Annual Reporting

On an annual basis, a board must assess the adequacy and effectiveness of the adviser's fair valuation process. At minimum, this assessment must summarize the results of testing of fair value methodologies and the adequacy of resources allocated to the valuation designee's fair valuation process, including material changes to the roles or functions of personnel responsible for determining fair value.

The Release states that these requirements are intended to supplement, rather than replace, board oversight and that

fund boards may seek additional information, such as specific calibration and back-testing data, pricing error reports, pricing service due diligence information and summaries of price challenges. The Release provides that these reports may take the form of "narrative summaries, graphical representations, statistical analyses, dashboards, or exceptions-based reporting, among other things."

Prompt Reporting

The Rule also requires that a valuation designee provide the board with written notification of any matters that materially affect the fair value of a designated portfolio of investments no later than 5 days after the valuation designee becomes aware of the matter. Such material matters include, but are not limited to, 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 its net asset value. The board may also request that the valuation designee provide follow-up reports on the matters, if reasonably determined that such reports are appropriate.

Readily Available Market Quotations

A board's role in the valuation of a portfolio holding for purposes of fair value depends on whether the market quotations are readily available for such a holding. A market quotation is defined as "readily available" when the "quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable." This definition is consistent with the definition of a Level 1 input in the fair value hierarchy outlined in the Generally Accepted Accounting Principles ("U.S. GAAP"). Therefore, under the final definition, a security is considered to have readily available market quotations if its value is determined by reference to the Level 1 inputs.

The adopted definition of readily available market quotations applies to the entirety of the Act and the rules thereunder. Mutual funds and other pooled investment vehicles with daily net asset values are considered to have readily available market quotations. However, certain securities that have been previously viewed as having readily available market quotations and being available to cross trade under rule 17a-7 may not meet the new definition and would therefore not be available for such trades. The Release indicates that the definition of "readily

available” was constructed to be consistent with the definition of a Level 1 input as set forth in the U.S. generally accepted accounting principles (GAAP). Accordingly, affiliated cross trades under rule 17a-7 would be prohibited for non-Level 1 securities (e.g., fixed income securities).

Recordkeeping

The Commission adopted rule 31a-4 (the “Recordkeeping Rule”), which requires registered investment companies and business development companies to maintain documentation to support fair market value determinations. The required documentation must be such that a third party could verify, but not fully recreate, the fair value determination. The type of documentation that must be maintained to meet this requirement will depend on the security or fair value methodology used.

Under the Recordkeeping Rule, the fund is required to maintain the records unless the board has designated the performance of fair value determinations to the fund’s investment adviser. In that case, the investment adviser is responsible for maintaining the records. The records must be maintained for six years, with the first two in an easily accessible place.

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. These records must also be maintained for six years, with the first two in an easily accessible place.

Rescission of Prior Commission Releases, Guidance, No-Action Letters

The Commission noted that since it issued ASR 113 and ASR 118, developments in the Financial Accounting Standards Board’s (the “FASB”) accounting standards, and market and fund investment practices have modernized and evolved. As such, 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. Therefore, ASR 113 and ASR 118 are rescinded in their entirety.

Upon the compliance date of the rules, 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 moot, superseded, or otherwise

inconsistent with the rules and, therefore, will be withdrawn or rescinded.

Transition Period

The compliance date will be 18-months following the effective date of the rules. Once the rules become effective, a fund may voluntarily comply with the rules in advance of the compliance date. The rules will become effective 60 days after they are published in the Federal Register. However, any fund that elects to rely on rules 2a-5 and 31a-4 prior to the compliance date may not 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) of the Act and rule 2a-4 thereunder. ASR 113 and ASR 118 will be rescinded on the compliance date.

FOR MORE INFORMATION

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