

CLIENT ALERT

# SEC Adopts Fair Valuation Rule for Registered Funds and BDCs

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## AUTHORS

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The Securities and Exchange Commission (the “SEC”) adopted new Rule 2a-5 (the “Final Rule”) under the Investment Company Act of 1940 (the “1940 Act”) on December 3, 2020, providing a framework for the fair valuation of portfolio investments of registered open-end and closed-end investment companies (“registered funds”) and business development companies (“BDCs,” and with registered funds, “funds”).<sup>1</sup> Under Section 2(a)(41) of the 1940 Act, securities in a fund’s portfolio for which market quotations are readily available must be valued at their market value, and all other securities and assets must be valued at their “fair value as determined in good faith by the [fund’s] board of directors.” The SEC also adopted new Rule 31a-4 under the 1940 Act, which contains recordkeeping requirements relating to the Final Rule.

The Final Rule requires:

- the performance of certain enumerated activities to determine in good faith the fair value of fund investments for purposes of Section 2(a)(41); and

<sup>1</sup> Good Faith Determinations of Fair Value, 1940 Act Release No. 34,128 (Dec. 3, 2020), 86 Fed. Reg. 748 (Jan. 6, 2021) available [here](#) (the “Adopting Release”). The Final Rule applies to all registered funds and BDCs, regardless of their classification or sub-classification or their investment objectives or strategies. The Final Rule also includes a specific provision relating to fair valuation determinations by a unit investment trust as defined in the 1940 Act (“UIT”).

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- the assessment and management of valuation risks (including conflicts of interest), the establishment and application of fair value methodologies, the testing of fair value methodologies and the evaluation of pricing services.

Additionally, a fund's board of directors<sup>2</sup> may designate a "valuation designee" (generally, the investment adviser to the fund) so long as the board or such valuation designee takes certain actions, including implementing certain board oversight procedures and reporting. The scope of the changes, if any, to current valuation practices that will result from implementation of the Final Rule's requirements by a fund's investment adviser and board will likely vary across the industry, depending on the fund's existing valuation arrangements, including the role currently played in the valuation process by the fund's investment adviser, sub-adviser(s) or other service provider(s) (such as a third-party administrator) in the valuation process.

The Final Rule defines when market quotations are "readily available" for purposes of Section 2(a)(41).<sup>3</sup> Under the definition, a market quotation is readily available "only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable."<sup>4</sup> This definition limits securities for which market quotations are readily available to "level 1" securities under the framework established for the purposes of U.S. Generally Accepted Accounting Principles ("U.S. GAAP") by ASC Topic 820.<sup>5</sup> The Adopting Release states that this definition will apply to all provisions of the 1940 Act and rules thereunder that use this term.<sup>6</sup> This includes Rule 17a-7, and the new definition is expected to limit funds' ability to engage in cross-trades of securities in certain asset classes, particularly many types of fixed income securities.

Importantly, the Adopting Release states that a violation of the Final Rule does not necessarily mean that a fund has ascribed inappropriate values to its assets, which would result in a violation of other provisions of the 1940 Act. Rather, a violation of the Final Rule "call[s] into question the effectiveness of the fund's *fair value process and its compliance program*."<sup>7</sup>

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<sup>2</sup> For purposes of the Final Rule, "board" means either the fund's entire board of directors or a designated committee of such board composed of a majority of directors who are not interested persons of the fund. Rule 2a-5(e)(3). Because a UIT does not have a board of directors or investment adviser, a UIT's trustee or depositor will normally be required to conduct fair value determinations in accordance with the provisions of Rule 2a-5(d). See note 41 *infra*.

<sup>3</sup> Rule 2a-5(c).

<sup>4</sup> *Id.*

<sup>5</sup> FASB Accounting Standard Codification Topic 820: Fair Value Measurement ("ASC Topic 820").

<sup>6</sup> See Adopting Release at 94.

<sup>7</sup> Adopting Release at 12 (emphasis added). For example, the Adopting Release notes that an incorrect valuation, as opposed to a non-compliant fair value process, could result in a violation of Rule 22c-1 under the 1940 Act, which requires investment companies that issue redeemable securities to redeem such securities at net asset value.

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**Compliance Date.** With the adoption of the Final Rule, certain previously issued SEC guidance, staff letters, and other staff guidance addressing fund valuation matters covered by the Final Rule are being withdrawn.<sup>8</sup> Rules 2a-5 and 31a-4 will be effective March 8, 2021. The compliance date will be 18 months following the effective date of the rules. A fund may choose to comply with the new rules prior to the compliance date, but would in that case not also be permitted to rely on any prior guidance that will be rescinded.

The Final Rule may be subject to further review by the SEC. On January 20, 2021, President Biden's chief of staff Ron Klain issued a memorandum to the heads of executive departments and agencies ordering an immediate freeze on the proposal or issuance of any new rules, pending review and approval by the Biden administration, subject to certain limited exceptions, and also directing such heads to take certain actions with respect to rules that were adopted prior to January 20, 2021, that had not yet taken effect.<sup>9</sup> Although as an independent agency the SEC is not subject to the memorandum, the SEC may seek to follow its past practice and voluntarily submit to the mandates outlined in the memorandum with respect to certain recently adopted rules, including the Final Rule.

### Framework for Determining Fair Value in Good Faith

Section 2(a)(41)(B) of the 1940 Act generally defines "value" to mean "(i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors." The Final Rule contains the following requirements for determining fair value in good faith that will be applicable to all fair value determinations:

#### *I. Valuation Risks*

Under the Final Rule, determining fair value in good faith requires periodic assessment and management by the board or the valuation designee of material risks associated with fair value determinations.<sup>10</sup> The only valuation risk that is specifically identified in the Final Rule that must be addressed is the existence of material conflicts of interest, as any other specific valuation risks would depend on the facts and circumstances of a particular fund's investments. Valuation risks may include the risks associated with the initial determination of whether an investment must be fair valued, as well as valuation risks that may arise from the following potential sources, among others:<sup>11</sup>

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<sup>8</sup> The valuation and pricing services guidance in Money Market Fund Reform; Amendments to Form PF, 1940 Act Release No. 31,166 (July 23, 2014) (the "2014 Money Market Fund Release") is also superseded by the Final Rule.

<sup>9</sup> See Memorandum from Ronald A. Klain, Assistant to the President and Chief of Staff, to the Heads of the Executive Departments and Agencies (Jan. 20, 2021), available [here](#). Our client alert discussing the impact of the Biden administration's regulatory freeze is available [here](#).

<sup>10</sup> Rule 2a-5(a)(1).

<sup>11</sup> Adopting Release at 16–17.

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- 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 (indicators of which could include a significant change in trading volume, a significant change in short-term volatility or market liquidity, or a sudden increase in trading suspensions) 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 is fair valued as determined in good faith, and their contribution to its 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; 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 frequency for the required assessment of a fund's valuation risks is not specified in the Final Rule. Determination of the frequency of such valuation risk assessment should take into account changes in fund investments, significant changes in a fund's investment strategy or policies, market events, and other relevant factors.

### *II. Fair Value Methodologies*

The Final Rule provides that determining fair value in good faith requires the board or valuation designee, as applicable, to select and apply in a consistent manner an appropriate methodology or methodologies for determining (and calculating) the fair value of fund investments. This requirement includes specifying the key inputs and assumptions specific to each asset class or portfolio holding. In a departure from the version of Rule 2a-5 proposed in April 2020 (the "Proposed Rule"),<sup>12</sup> 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 investments.<sup>13</sup> Further, the Adopting Release clarifies that a board or valuation designee may use different methodologies for different securities within the same asset

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<sup>12</sup> See Good Faith Determinations of Fair Value, Investment Company Act Release No. 33845 (Apr. 21, 2020), 85 FR 28734 (May 13, 2020) (the "Proposing Release").

<sup>13</sup> See Adopting Release at 20.

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class.<sup>14</sup> The appropriateness of the selected methodologies will have to be periodically reviewed, and the selected methodologies adjusted as necessary. Such periodic review may include modifying an existing methodology or changing to a new methodology entirely.<sup>15</sup> Additionally, in another modification of the Proposed Rule, the Final Rule does not require the specification of methodologies that will apply to new types of investments in which the fund intends to, but does not currently, invest.<sup>16</sup>

As discussed further below under “Definition of Readily Available Market Quotations,” any methodology used for purposes of determining fair value must be consistent with U.S. GAAP, including the criteria established in ASC Topic 820.<sup>17</sup> Supplemental methodologies for situations not explicitly outlined in ASC Topic 820 may be appropriately applied by a board or valuation designee, provided that the methodologies are not inconsistent with the principles outlined in ASC Topic 820.<sup>18</sup> The Adopting Release acknowledges that no single methodology for determining fair value would be applicable to all investments due to the particular facts and circumstances of each investment that shape its fair value, including the relevant market and market participants.<sup>19</sup>

The Final Rule also requires that a fund’s board or valuation designee monitor for circumstances or significant events that, if manifested, would make market quotations unreliable and thus, for purposes of the Final Rule, not readily available,<sup>20</sup> thus necessitating a fair value determination in good faith.<sup>21</sup> The Final Rule reflects a change from the Proposed Rule and does not require the board or the valuation designee to establish specific criteria for determining when market quotations are no longer reliable and, therefore, not readily available. Instead, the board or the valuation designee is provided flexibility to consider the full range of conditions that may affect reliability.

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<sup>14</sup> *Id.* at 19.

<sup>15</sup> *Id.* at 25.

<sup>16</sup> *Id.* at 19.

<sup>17</sup> ASC Topic 820’s alternative approaches to fair valuation are: market approach (using prices and other information generated from market transactions in similar assets and liabilities), income approach (using a discounting methodology to convert future amounts to a current amount), and cost approach (based on the amount required to replace an asset’s service capacity), as well as other valuation techniques and methods as ways in which to measure fair value. Adopting Release at 21, n.58; see *also* Proposing Release at 20.

<sup>18</sup> Adopting Release at 21–22. The Final Rule supersedes guidance in the 2014 Money Market Fund Release relating to the valuation of thinly traded securities. *Id.* at 22–23.

<sup>19</sup> *Id.* at 22–23.

<sup>20</sup> See *infra*, note 62.

<sup>21</sup> Rule 2a-5(a)(2)(C).

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### III. Testing Fair Value Methodologies

The Final Rule requires that funds test fair value methodologies, including testing the appropriateness and accuracy of the fair value methodologies selected.<sup>22</sup> The Final Rule also requires the board or valuation designee to identify the testing methods to be used, and the minimum frequency of the testing, but does not require particular testing methods or a minimum frequency for the testing.<sup>23</sup> The Adopting Release cites calibration and back-testing as examples of useful methods for identifying trends, poor performance of fair value methodologies applied by fund service providers, or potential conflicts of interest, but does not require use of these testing methods.<sup>24</sup> The Final Rule provides flexibility to allow funds to utilize new, appropriate testing methods as they become more prominent or useful.<sup>25</sup>

### IV. Oversight of Pricing Services

The Final Rule requires oversight and evaluation of any pricing services used by a fund. “[G]iven 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.”<sup>26</sup> Specifically, the board or valuation designee must establish a process for approving, monitoring, and evaluating each pricing service provider, and a process for initiating price challenges. Before deciding to use a pricing service, factors such as the following should generally be taken into account:<sup>27</sup>

- 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. In this regard, in considering a pricing service, valuation method or technique, the fair value policies and procedures should address whether the pricing service is relying on inputs or assumptions provided by the valuation designee or its affiliates;<sup>28</sup>
- 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;

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<sup>22</sup> Rule 2a-5(a)(3).

<sup>23</sup> Rule 2a-5(a)(3).

<sup>24</sup> Adopting Release at 141.

<sup>25</sup> *Id.* at 29.

<sup>26</sup> *Id.* at 32.

<sup>27</sup> *Id.* at 37.

<sup>28</sup> *Id.* at 36, n.117. See also *id.*, Section II.B.3 (“Specifications of Functions”) at 76.

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- 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.

The Adopting Release states that the 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, as applicable, does not have a good faith basis for believing that the pricing service’s pricing methodologies produce prices that reflect fair value.<sup>29</sup>

The board or valuation designee, as applicable, must also establish a *process* for initiating price challenges as appropriate. This is a modification to the Proposed Rule, which would have required the establishment of criteria for the circumstances under which price challenges would have been initiated. The process under the Final Rule should generally outline the circumstances under which a pricing challenge should be initiated. A valuation designee’s process for initiating pricing challenges is subject to board oversight under the Final Rule.<sup>30</sup>

### V. *Fair Value Policies and Procedures*

In a change from the Proposed Rule, the Final Rule does not include the requirement that a fund adopt and implement written policies and procedures reasonably designed to achieve compliance with the Final Rule. Instead, the SEC simultaneously adopted companion Rule 31a-4, which requires a fund or the board’s valuation designee to “maintain appropriate documentation to support fair value determinations”<sup>31</sup> and requires various periodic reports to a fund’s board as described below under “Board Oversight Through Valuation Designee Reporting—Periodic Reporting.” The Adopting Release also states that “appropriate documentation” does not require detailed records relating to the specific methodologies that a pricing service applied, nor the assumptions or inputs used by such pricing service to form the basis of the fair value determination.<sup>32</sup> Rather, “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 [SEC] staff, not involved in the preparation of the fair value determinations to verify, but not fully recreate, the fair value determination.”<sup>33</sup>

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<sup>29</sup> See Adopting Release at 37.

<sup>30</sup> *Id.* at 32–33. The views expressed in the Adopting Release supersede the guidance the SEC previously provided in the 2014 Money Market Fund Release regarding the use of pricing services.

<sup>31</sup> *Id.* at 81.

<sup>32</sup> *Id.* at 82.

<sup>33</sup> *Id.* at 85.

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Funds and advisers will be generally required to maintain these records for at least six years, the first two years in an easily accessible place.<sup>34</sup>

Because Rules 2a-5 and 31a-4 are new rules under the 1940 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>

### Designation of Valuation Designee

The Final Rule provides that a fund's board may choose to determine fair value in good faith for any or all fund investments by carrying out all required functions, including, among other things, monitoring for circumstances that necessitate fair value determinations and selecting and applying valuation methodologies.<sup>36</sup> Under the Final Rule, a fund's board can designate a valuation designee, which is defined by the Final Rule as "the investment adviser, other than a sub-adviser, of a fund or, if the fund does not have an investment adviser, an officer or officers of the fund."<sup>37</sup> The valuation designee will be subject to board oversight and additional reporting, recordkeeping, and other requirements intended to facilitate the board's oversight of the designee's fair value determinations, as discussed below.<sup>38</sup> The Adopting Release acknowledges that few fund boards today are directly involved in the day-to-day valuation tasks required to determine fair value, and that many of these tasks are often performed by the fund's investment adviser pursuant to long-standing SEC and staff guidance.<sup>39</sup>

In a change from the Proposed Rule, the Final Rule does not permit a board to designate a sub-adviser as the valuation designee to perform fair valuation determinations,<sup>40</sup> but does permit designation to an officer of the fund if the fund is internally managed.<sup>41</sup> Some commenters had suggested expanding the pool of potential designee beyond the investment

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<sup>34</sup> Rule 31a-4(b).

<sup>35</sup> Adopting Release at 39.

<sup>36</sup> See Rule 2a-5(b).

<sup>37</sup> See Rule 2a-5(e)(4).

<sup>38</sup> See Rule 2a-5(e)(4). The Proposed Rule stated that a board could "assign" the task of determining the fair value of a security to an investment adviser, but the Final Rule instead provides that a board may "designate" this task to a valuation designee. The Adopting Release indicates that the change from "assign" to "designate" is meant to clarify that a valuation designee's determinations of fair value are subject to board oversight. See Adopting Release at 42.

<sup>39</sup> See Adopting Release at 108.

<sup>40</sup> The board or investment adviser as valuation designee can seek the assistance of sub-advisers as it deems appropriate. *Id.* at 47.

<sup>41</sup> If the fund is a UIT, this role may be filled by a trustee or depositor or, if the UIT is already in existence and the securities being valued were deposited in the UIT prior to the effective date of the Final Rule, the parties specified as evaluators in the UIT's trust indenture or similar document. *Id.* at 49.



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adviser to any affiliate of the adviser, fund administrators or affiliates, or committees composed of a blend of personnel or officers of the adviser or administrator, or certain other third parties that the board determined to have sufficient expertise and capacity to fulfill the role. The SEC declined to expand the universe of potential designees: “We generally decline to expand permissible designees beyond the adviser in the [Final Rule] because we believe that it is critical for the entity actually performing the fair value determination to owe a fiduciary duty to the fund and be subject to board oversight whenever possible.”<sup>42</sup> The Adopting Release notes that if the fund’s investment adviser also acts as the fund’s administrator, it can only serve as the valuation designee as the investment adviser.<sup>43</sup> The scope of the changes, if any, to current valuation practices that will result from implementation requirements applicable to a fund’s investment adviser and board under the Final Rule will vary by fund complex, depending on the fund’s current structure and valuation arrangements, including the role currently played in the valuation process by the fund’s investment adviser, sub-adviser(s) or other service provider (such as a third-party administrator).

### *I. Board Oversight Generally*

The Final Rule provides extensive and specific board oversight obligations (as detailed below) if fair value determinations are performed by a “valuation designee.”<sup>44</sup> The Adopting Release reaffirms the view of the SEC articulated in the Proposing Release, stating that “appropriate oversight cannot be a passive activity,” and that boards should “ask questions and seek relevant information” in assessing a valuation designee’s valuation determinations.<sup>45</sup> Boards are expected to oversee the valuation designee with an appropriate level of scrutiny relative to the fund’s valuation risk, and to question the appropriateness of the valuation designee’s fair value processes, including through oversight over conflicts of interest.<sup>46</sup> The Adopting Release identifies approaches by which boards may fulfill their oversight role, stating that boards should be “skeptical and objective” and, to the extent that the fair value of a fund’s investments depends on subjective inputs, boards may need to increase their level of scrutiny.<sup>47</sup>

The SEC received numerous comments on the Proposed Rule with respect to the oversight role of boards. Some commenters asked the SEC to clarify that boards do not have a specific duty to seek to discover conflicts of interest, and others stated that “board[s] should be able to rely upon the adviser much the same way that it can reasonably rely upon others, such as fund CCOs, administrators, and counsel.”<sup>48</sup> However, the Adopting Release restates the view from the

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<sup>42</sup> Adopting Release at 44 (note omitted).

<sup>43</sup> *Id.* at 45.

<sup>44</sup> See discussion *supra*, note 41.

<sup>45</sup> Adopting Release at 56.

<sup>46</sup> *Id.* at 57–58.

<sup>47</sup> *Id.* at 56.

<sup>48</sup> *Id.* at 54.

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Proposing Release that it is incumbent upon boards to identify potential conflicts of interest of the valuation designee and other service providers as part of their oversight duties.<sup>49</sup>

Commenters also asked the SEC to confirm that the board's oversight role under the Final Rule could be discharged consistent with business judgment rules under state laws, but this general approach was rejected by the SEC in favor of more specific guidance on the role of fund boards.<sup>50</sup> For example, the Adopting Release states that boards should "probe the appropriateness of the valuation designee's fair value process" and explains that boards should not rely solely on the Final Rule's reporting processes in their oversight role: "While a board can reasonably rely on the information provided to it in summaries and other materials provided by the valuation designee and other service providers ... it is incumbent on the board to request and review such information as may be necessary to be informed of the valuation designee's process for determining the fair value of fund investments."<sup>51</sup> The Adopting Release also notes that boards should periodically review the financial resources, technology, staff, and expertise of the valuation designee (including the reasonableness of the valuation designee's reliance on other fund service providers) as they relate to valuation.<sup>52</sup> In addition, boards should consider the valuation designee's compliance capabilities, financial resources, and the oversight available for supporting the fund's fair value processes.<sup>53</sup>

### *II. Specification of Functions at the Valuation Designee*

The Final Rule requires the valuation designee to specify the titles and particular functions of each person responsible for determining the fair value of the assigned investments.<sup>54</sup> 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.<sup>55</sup> The Adopting Release acknowledges that portfolio management personnel can provide important perspectives with respect to the value of a fund holding and indicates that the segregation requirement does "not prevent portfolio managers from providing inputs that are used in the process for determining fair value."<sup>56</sup> However, a portfolio manager may not exert "substantial influence on" fair values ascribed to portfolio investments, and valuation

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<sup>49</sup> *Id.* at 55.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.* at 59.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> Rule 2a-5(b)(2). To the extent the valuation designee uses a valuation committee or similar body to assist in the process of determining fair value, the fair valuation policies and procedures are expected to describe the composition and role of such committee, or reference any related committee governance documents as appropriate. Adopting Release at 77, n.284.

<sup>55</sup> Rule 2a-5(b)(2). The valuation designee of an internally managed fund would also be required to reasonably segregate fair value determinations from the portfolio management of the fund. Adopting Release at 77, n.286.

<sup>56</sup> Adopting Release at 80 and Final Rule 2a-5(b)(2).

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designees may “seek to provide independent voices as a check on any potential conflicts of interest to the extent appropriate.”<sup>57</sup>

### *III. Board Oversight Through Valuation Designee Reporting*

Under the Final Rule, many of the board’s oversight responsibilities are intertwined with specific board reporting requirements, as described below. The valuation designee’s reports must include information reasonably necessary for the board to evaluate the matters covered in the reports.

#### *a. Periodic Reporting*

The Final Rule requires the valuation designee to provide the board with quarterly and annual written assessments of the valuation designee’s fair value determination processes.<sup>58</sup> These reports must be sent to either the full board or a committee tasked with overseeing valuations, which must consist of at least a majority of non-interested directors.<sup>59</sup>

*Quarterly Reports.* The valuation designee must provide, at least quarterly, in writing: (i) any reports or materials requested by the board related to the fair value of the portfolio or the valuation designee’s process for fair valuing fund investments;<sup>60</sup> and (ii) a summary or description of material fair value matters<sup>61</sup> that occurred in the prior quarter.<sup>62</sup> Such summary or description must include:

- (1) any material changes in the assessment and management of valuation risks, including any material changes in conflicts of interest of the valuation designee (and any other service provider);
- (2) any material changes to, or material deviations from, the fair value methodologies; and
- (3) 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>63</sup>

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<sup>57</sup> Adopting Release at 81.

<sup>58</sup> Rule 2a-5(b)(i).

<sup>59</sup> Rule 2a-5(e)(3).

<sup>60</sup> Rule 2a-5(b)(i)(A)(1).

<sup>61</sup> Material fair value matters are matters about which the board would reasonably need to know in order to exercise appropriate oversight of the valuation designee’s fair value determination process. Adopting Release at 66.

<sup>62</sup> Rule 2a-5(b)(i)(A)(2).

<sup>63</sup> Rule 2a-5(b)(i)(A)(2).

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*Annual Report.* The annual report of the valuation designee must include an assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of the designated portfolio of investments, including, at a minimum:

- a summary of the results of the testing of fair value methodologies; and
- 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.<sup>64</sup>

These reports are the minimum required by the Final Rule - a board is free to require that a valuation designee provide more detailed or frequent reports.

The SEC received many comments on the prescriptive nature of the reports required by the Proposed Rule and in response made several changes from the Proposed Rule, such as eliminating the requirement that changes in service providers used and price overrides be included in quarterly reports.<sup>65</sup> The Final Rule also does not include the proposed requirement that each quarterly report include a summary of the assessment and management of material valuation risk.<sup>66</sup>

### *b. Prompt Board Notification of Material Matters*

The Final Rule requires the valuation designee to notify the board promptly of the occurrence of matters that materially affect the fair value of the designated portfolio of investments. These matters may include, for example, a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process or material errors in the calculation of net asset value. The valuation designee must notify the board 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 matter), with such timely follow-on reporting as the board may determine to be appropriate.<sup>67</sup> If a valuation designee is aware of a matter that may affect the fair valuation of the designated portfolio of investments but has not been able to determine the matter's materiality within 20 business days, it must inform the board of its ongoing evaluation within five business days.<sup>68</sup>

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<sup>64</sup> Rule 2a-5(b)(i)(B).

<sup>65</sup> See Adopting Release at 66.

<sup>66</sup> *Id.*

<sup>67</sup> Final Rule 2a-5(b)(1)(ii).

<sup>68</sup> Adopting Release at 75.

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### Definition of Readily Available Market Quotations

Under Section 2(a)(41) of the 1940 Act, securities must be fair valued as determined in good faith by the board when market quotations are not “readily available.”<sup>69</sup> Neither the 1940 Act nor the rules thereunder currently define “readily available” for purposes of Section 2(a)(41). The Final Rule defines the term as follows:

a market quotation is readily available only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable.<sup>70</sup>

As discussed above, the Adopting Release generally refers to U.S. GAAP for appropriate valuation standards.<sup>71</sup> In setting out the definition for when market quotations are “readily available,” the Adopting Release specifically refers to ASC Topic 820’s definition of level 1 assets.<sup>72</sup> This reflects a change from the current “facts and circumstances” framework.<sup>73</sup>

A security (such as a fixed income security) that is priced using a pricing service’s evaluated price is generally considered to be a level 2 security for purposes of ASC Topic 820, and would therefore not be a security for which market quotations are readily available under the definition. As a result, such securities will be subject to fair value determinations under the Final Rule.<sup>74</sup>

The Final Rule also provides that a quotation is not readily available if it is not reliable.<sup>75</sup> A quotation would be considered to be unreliable if it would require adjustment under U.S. GAAP or may require additional consideration or inputs in order to determine the value of the security, such as may be needed for a security that principally trades on a closed foreign market when an event occurs prior to the fund calculating its NAV that would likely result in a change in its price.<sup>76</sup>

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<sup>69</sup> Section 2(a)(41)(B)(ii) of the 1940 Act. See also 1940 Act rule 2a-4.

<sup>70</sup> Rule 2a-5(c).

<sup>71</sup> See, e.g., Adopting Release at 91-92. See also Proposing Release at 59. See also “Fair Value Methodologies” *supra*, notes 12–21.

<sup>72</sup> Adopting Release at 90. The Adopting Release acknowledges that the proposed definition taken from ASC Topic 820 is different from the one in Statement Regarding “Restricted Securities,” Accounting Series Release No. 113, 35 FR 19986 (Dec. 31, 1970) (together with Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118, 35 FR 19986 (Dec. 31, 1970), the “ASR Releases”), which refers to “securities similar in all respects,” rather than “identical assets,” but asserts that “we view these respective definitions as being substantively the same.” See *Id.* at 89, n.336.

<sup>73</sup> See “An Introduction to Fair Value Pricing,” Investment Company Institute (Spring 2005) at 11.

<sup>74</sup> “As we stated in the proposal, under the final rule, evaluated prices are not readily available market quotations as they are not based upon unadjusted quoted prices from active markets for identical investments.” Adopting Release at 91, citing to Proposing Release at 59, nn.133-134 and accompanying text.

<sup>75</sup> *Id.* at 89.

<sup>76</sup> *Id.* at 93.

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## SEC Adopts Fair Valuation Rule for Registered Funds and BDCs

### *I. Cross-Trading*

The Adopting Release states that “a number of commenters raised concerns that the proposed definition of readily available market quotations may affect current practices on cross-trades.”<sup>77</sup> Rule 17a-7 under the 1940 Act permits cross-trades of securities between, among others, affiliated investment companies, subject to certain requirements, including that the security involved in the cross-trade have a “readily available market quotation.”<sup>78</sup> Commenters noted that certain fixed income securities (i.e., level 2 securities under ASC Topic 820) would not meet the definition of a readily available market quotation under the Final Rule and asked the SEC to clarify that Rule 2a-5 was not “meant to disrupt current cross-trading practices.”<sup>79</sup>

Citing the adopting release for Rule 17a-7,<sup>80</sup> the Adopting Release states that cross-trades will be subject to the definition of readily available market quotations in the Final Rule.<sup>81</sup> The Adopting Release also notes that SEC staff will review staff no-action letters relating to the definition of readily available market quotations in the context of cross-trades to determine whether any should be withdrawn. The Adopting Release also states that the SEC is considering potential revisions to Rule 17a-7 and solicits input from the public on their considerations.<sup>82</sup>

If Rule 17a-7 cross-trades are limited to level 1 securities, many fixed income securities will be eliminated from the possibility of being cross-traded. This substantial change in permissible cross-trading practices has not been well received in the fund industry and will likely be the subject of further comment and, possibly, future regulatory action.

### **Records Related to Fair Valuation Determinations**

In response to comments, the SEC removed the recordkeeping requirement from the Final Rule and instead adopted a new Rule 31a-4 under the 1940 Act. The Adopting Release states that this change will “centralize investment company recordkeeping provisions and ... also ensure that a failure to keep the required records would not lead to a board being found to have not fair valued in good faith.”<sup>83</sup> Rule 31a-4 is substantially similar to the recordkeeping obligations that were

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<sup>77</sup> *Id.* at 92.

<sup>78</sup> Rule 17a-7(a).

<sup>79</sup> Adopting Release at 94.

<sup>80</sup> Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof, Investment Company Act Release No. 11676 (Mar. 10, 1981).

<sup>81</sup> Adopting Release at 94.

<sup>82</sup> *Id.* at 95.

<sup>83</sup> *Id.* at 83.

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originally proposed for inclusion in Rule 2a-5.<sup>84</sup> These records will generally be required to be maintained for six years from the time the determination was made, the first two years in an easily accessible place.

Rule 31a-4 requires funds to maintain appropriate documentation to support fair value determinations made pursuant to the Final Rule. In addition, if the board has appointed a valuation designee, then the fund is required to keep the reports and other information provided to the board under the Final Rule, as well as a specified list of the investments or investment types for which the valuation designee performs valuations.<sup>85</sup>

Unlike the Proposed Rule, neither the Final Rule nor Rule 31a-4 requires the maintenance of “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, the Adopting Release states that “appropriate documentation to support a fair value determination that takes into account inputs from pricing services consists of records related to the fund or valuation designee’s initial due diligence [of the pricing service] and records from its ongoing monitoring and oversight of the pricing services.”<sup>86</sup>

### Rescission of Prior SEC Releases and Review of Relevant Staff Guidance

Upon the compliance date of the Final Rule, the ASR Releases will be rescinded in their entirety.<sup>87</sup> In addition, certain staff letters and SEC and staff guidance addressing a board’s determination of fair value and other matters covered by the Final Rule will be withdrawn and rescinded.<sup>88</sup>

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<sup>84</sup> *Id.* at 81.

<sup>85</sup> Rule 31a-4(a)–(b).

<sup>86</sup> Adopting Release at 86.

<sup>87</sup> Adopting Release at 162.

<sup>88</sup> Among the specified items to be withdrawn and rescinded are two letters issued to the Investment Company Institute, which have been frequently looked to by the industry since they were issued on December 8, 1999 and April 30, 2001. Other items to be withdrawn include, but are not limited to, Form N-7 for Registration of Unit Investment Trusts under the Securities Act of 1933 and the 1940 Act, 1940 Act Release No. 15,612, Appendix B, Guide 2 (Mar. 17, 1987); last paragraph of Section III.D.2.(a) and the entirety of Section III.D.2.(b) of the 2014 Money Market Fund Release; and Valuation Guidance Frequently Asked Questions (FAQ 1 only) (2014).

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## SEC Adopts Fair Valuation Rule for Registered Funds and BDCs

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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