



# FUND BOARD VIEWS

## Viewpoints

### **Board oversight of valuation: Key takeaways from the new rule**

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Fund boards have a fundamental responsibility under the Investment Company Act of 1940 to fair value a fund's securities. Specifically, each registered investment company or business development company is required to calculate its net asset value per share based on a determination of the current value of the fund's portfolio securities and other assets. If a market quotation is readily available for a portfolio security, it must be valued at the market price; however, if market quotations are unreliable or otherwise not readily available (or if the holding is not a security), the investment must be fair valued as determined in good faith by the fund's board of directors.

In December 2020, the Securities and Exchange Commission adopted Rule 2a-5 under the 1940 Act, which provides a new framework for fund valuation practices, including the role of the fund's board of directors.<sup>1</sup> Prior to this rulemaking, the SEC had not comprehensively addressed fund valuation practices for over 50 years.



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The rule has two main parts, which (1) establish requirements for the determination of fair value in good faith, and (2) permit fund boards to designate the determination of fair value to a "valuation designee," subject to certain conditions and oversight. The rule became effective this month, on March 8, and the compliance date is Sept. 8, 2022.

#### **Rule 2a-5 provides four specific requirements for determining fair value in good faith.**

*Assess and Manage Valuation Risks.* The rule requires periodic assessments of any material risks associated with the determination of an investment's fair value, including material conflicts of interest, and the development of a mechanism for managing those identified risks. To help inform the process, the SEC provided a non-exhaustive list of examples of valuation risks.

*Establish and Apply Fair Value Methodologies.* The rule requires the selection and application of appropriate fair value methodologies, including stating the key inputs and assumptions specific to each asset class or portfolio holding. It also requires a periodic review of the appropriateness and accuracy of the methodologies

selected and making any necessary adjustments, as well as monitoring for circumstances that may necessitate the use of fair value (e.g., significant events in a foreign jurisdiction after market close).

Importantly, the SEC reiterated that it continues to believe that there is no single methodology for determining the fair value of an investment and that there may be a range of appropriate values. The SEC notes that an appropriate methodology must be consistent with those used to prepare the fund's financial statements and thus be consistent with the principles of the valuation approaches laid out in Accounting Standards Codification Topic 820, Fair Value Measurement, of the Financial Accounting Standards Board.

*Testing of Fair Value Methodologies.* The rule requires testing the appropriateness and accuracy of the fair value methodologies, including identification of the testing methods to be used and the minimum frequency with which such testing methods are to be performed, although it does not specify a minimum frequency. The SEC notes that back-testing and calibration can help identify trends in certain circumstances and potentially help identify issues with methodologies provided by service providers.

*Pricing Services.* If pricing services are used to help determine the fair value of fund investments, a process must be established for the approval, monitoring, and evaluation of each pricing service provider. The SEC provided a list of factors that should generally be considered before a decision is made to use a pricing service. The rule also requires the establishment of a process for initiating price challenges.

### **Fund boards remain responsible for the fair value determinations required by the 1940 Act but can designate the determination of fair value to a “valuation designee.”**

A fund board may choose to determine fair value in good faith for some or all of a fund's investments by carrying out the functions outlined above themselves, although this approach is expected to be rare. Alternatively, a board may designate such day-to-day determinations to a “valuation designee,” subject to the board's oversight. The board will not be required to approve or ratify the specific fair value determinations made by the designee.

The valuation designee may be the fund's adviser or an officer of the fund if the fund is internally managed but not a fund's sub-adviser or other parties (including adviser affiliates, fund administrators, pricing services, or accounting firms). The designee, in turn, is required to clearly specify the titles and functions of the persons responsible for fair valuations. The designee is required to reasonably segregate the process of making fair value determinations from the portfolio management function, though portfolio managers may provide inputs into the process. The SEC also provided other guidance about how the board and the designee could obtain assistance and input from others in fulfilling their valuation duties.

### **Fund boards retain significant valuation oversight responsibility under Rule 2a-5.**

The rule requires boards to actively oversee the valuation designee. The SEC emphasized that this should be viewed as an iterative process in which the board asks questions and seeks relevant information, requests follow-up information when appropriate, and takes reasonable steps to see that matters identified are addressed. In that regard, the SEC provided a number of specific recommendations on the identification of conflicts of interest; the resources, expertise, and compliance capabilities of the valuation designee; and the nature of board reporting, among other areas.

## **The valuation designee is required to provide periodic and ad hoc reports to the board.**

Rule 2a-5 requires the valuation designee to provide periodic and, in certain circumstances, prompt reports to the board regarding its performance in making fair value determinations. These reports can take various forms, such as narrative summaries, graphical representations, statistical analyses, dashboards, or exceptions-based reporting, among other methods. It is generally expected that funds, even those with robust existing board reporting on valuation, will be required to make changes to their reporting in order to comply with the rule. The board and the valuation designee should work together to determine the information and format that the board will find most useful in fulfilling its oversight role.

*Quarterly reporting.* The valuation designee must provide a quarterly written report with materials requested by the board related to the fair value of designated investments or the designee's process for fair valuing fund investments. The report also must include a summary or description of material fair value matters that occurred in the prior quarter, such as: any material changes in the assessment and management of valuation risks; any material changes to, or material deviations from, the fair value methodologies established; and material events related to the oversight of pricing services.

*Annual reporting.* The valuation designee must make an annual report to the board that includes an assessment of the adequacy and effectiveness of the fair value process. This must include, 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. Annual reporting is generally expected to resemble annual reports that fund boards currently receive on the compliance program and liquidity risk management program.

*Prompt reporting.* The valuation designee is required to report to the board, within five business days, matters that materially affect the fair value of portfolio investments, including a significant deficiency or material weakness in the design or effectiveness of the fair value process or a material error in the calculation of NAV.

## **The rule defines when market quotations are “readily available” using accounting principles (i.e., securities classified as Level 1 in the fair value hierarchy).**

“Readily available” is not currently defined in the 1940 Act or associated rules. Rule 2a-5 provides that a market quotation is readily available for purposes of the 1940 Act only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable. This standard is drawn from ASC Topic 820 and is consistent with the definition of a Level 1 input in the fair value hierarchy outlined in U.S. Generally Accepted Accounting Principles. Importantly, the SEC notes that evaluated prices (whether or not provided by third-party pricing services) and broker-dealer “accommodation quotes” are not by themselves readily available market quotations.

## **Rule 2a-5 may impact cross trades under Rule 17a-7 for securities that are not Level 1.**

Rule 17a-7 under the 1940 Act permits cross trading between a fund and another client of an investment adviser (e.g., another investment company or a separate account or hedge fund) if certain conditions are met. Among other things, Rule 17a-7 is only available for transactions in securities for which market quotations

are readily available. Given the formalized definition discussed above, the SEC stated that certain securities (in particular fixed-income securities) that previously have been viewed as having readily available market quotations and thus potentially available to cross trade under Rule 17a-7 may not meet the new definition and thus would not be available for such trades. In light of Rule 2a-5, the SEC is revisiting Rule 17a-7 and related staff relief.

### **The SEC adopted recordkeeping requirements related to fair value determinations.**

In conjunction with the adoption of Rule 2a-5, the SEC adopted new Rule 31a-4 under the 1940 Act to address the recordkeeping requirements that will be associated with fair value determinations. The SEC noted that appropriate documentation to support fair value determinations should include documentation that would be sufficient for a third party (such as the SEC staff) to verify, but not fully recreate, the fair value determination.

### **The board must approve fair value compliance policies and procedures.**

The compliance rule (Rule 38a-1 under the 1940 Act) requires the adoption and implementation of written policies and procedures reasonably designed to prevent violations of the requirements of Rules 2a-5 and 31a-4. As a technical matter, the SEC has indicated that these fair value policies and procedures must be presented to the board as new policies and procedures rather than material amendments to existing fair value policies and procedures, given the new fair value determination requirements and the intrinsic relationship of the new rules to the board's statutory function relating to valuation. The fund must adopt and implement fair value policies and procedures if the board determines fair value. The board can also fulfill its responsibilities under the compliance rule if an adviser serving as the valuation designee adopts such policies and procedures (without the need for the fund to adopt duplicative policies and procedures), which are then approved by the board.

### **The SEC rescinded long-standing guidance on valuation matters.**

With the adoption of Rule 2a-5, the SEC rescinded two prior releases, Accounting Series Release 113 (1969) and ASR 118 (1970), as well as certain SEC staff letters and guidance relating to fair value determinations and notes that any other staff guidance inconsistent or conflicting with the requirements of the rule is superseded. These releases and guidance are rescinded effective as of Sept. 8, 2022.

### **Independent auditors may modify their audit approach with respect to valuation (in advance of the compliance date).**

Guidance in ASR 118 states that independent auditors of funds should verify all quotations for securities with readily available market quotations, which implicates the auditor's requirement to test the valuation assertion for all securities when auditing a fund's financial statements. The SEC notes that rescinding this guidance would allow fund auditors to apply only Public Company Accounting Oversight Board standards, which would in turn permit sampling and other techniques to verify the value of a fund's investments.

The SEC staff issued guidance that it would not object if an independent auditor chooses to stop looking to the auditing guidance contained in ASR 118 and instead determines the appropriate audit approach by following only the relevant PCAOB auditing standards any time after March 8, 2021, which would include fiscal periods ending on or after March 31, 2021.<sup>2</sup> While this will provide the auditors with greater flexibility

in carrying out their audit procedures, a fund board (or valuation designee) could request that the auditor continue its current practice to verify 100% of the values of the fund's investments. This change in process, if implemented by audit firms, should be communicated to the board by the auditor as part of the audit planning process.

### **Funds are required to comply with Rule 2a-5 by September 2022.**

As noted above, the compliance date for the rule is Sept. 8, 2022. Implementation may require significant resources (particularly from fund advisers expected to serve as valuation designees) and must be completed on a timeline that is similar to other new SEC rules that are applicable to many funds, including both fund use of derivatives and fund-of-funds arrangements.<sup>3</sup> It is still early in the implementation period, and best practices are still developing.

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[1] Good Faith Determinations of Fair Value, 1940 Act Release No. IC-34128 (Dec. 3, 2020).

[2] Valuation Frequently Asked Questions (updated March 1, 2021), available at <https://www.sec.gov/investment/valuation-faq>.

[3] Fund of Funds Arrangements, 1940 Act Release No. 34045 (Oct. 7, 2020); Use of Derivatives by Registered Investment Companies and Business Development Companies, 1940 Act Release No. 34078 (Oct. 28, 2020).