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SEC Updates Framework for Fund Fair Valuation Practices: Ropes & Gray

On December 3, 2020, the SEC issued a [release](#) adopting Rule 2a-5 (the “Rule”) under the 1940 Act (the “Release”).¹ The Rule is intended to “address valuation practices and the role of the board of directors with respect to the fair value of the investments of a registered investment company or business development company.” The Rule will permit a fund’s board to designate the fund’s primary investment adviser to perform the fund’s fair value determinations, which will be subject to board oversight and certain reporting and other requirements intended to ensure that the board receives the information it needs to oversee the investment adviser’s fair value determinations. Most notably:

- The Rule specifies the minimum requirements of a program for determining the fair value of fund investments in good faith for purposes of the 1940 Act.
- The Rule permits a fund’s board² to formally designate the fund’s primary investment adviser as its “valuation designee” to perform fair value determinations for the fund.³
- If a fund’s investment adviser is designated as the board’s fair valuation designee, the Rule provides that the investment adviser will be subject to board oversight and detailed reporting, recordkeeping and other requirements intended to enhance the board’s oversight of the investment adviser’s fair value determinations.
- The Release rescinds certain previously issued fair valuation guidance, including guidance on the role of a fund’s board in determining the fair value of fund investments.
- The Rule defines the criteria for concluding that a market quotation is “readily available,” which is currently undefined under the 1940 Act or rules thereunder. The definition will apply **for all** 1940 Act purposes, including Rule 17a-7 transactions. As a result, depending on further guidance from the SEC regarding the status of various no-action letters and/or potential revisions to Rule 17a-7, Rule **17a-7 may no longer be available** for cross trades in most fixed income securities and other securities without “readily available market quotations” as defined in the Rule beginning no later than the compliance date.

The Rule reflects some modifications from the April 2020 [proposing release](#) (the “proposing release”), largely to address issues raised regarding more prescriptive elements of the initial proposal. We have noted changes from the proposing release in the footnotes to this Alert.

SUMMARY OF THE RULE

Requirements to determine fair values in good faith. The Rule provides that determining the fair value of a fund’s portfolio investments in good faith requires:

1. Periodically assessing any material risks associated with fair value determinations, including material conflicts of interest, and managing those identified valuation risks.
2. Establishing and applying fair value methodologies by performing each of the following, taking into account the fund’s valuation risks (a) selecting and applying in a consistent manner an appropriate methodology for determining (and calculating) the fair value of fund investments,

including specifying the key inputs and assumptions specific to each asset class or portfolio holding, (b) periodically reviewing the appropriateness and accuracy of the methodologies selected and making any necessary changes or adjustments thereto and (c) monitoring for circumstances that may necessitate the use of fair value. A selected methodology may be changed “provided [the new] methodology is equally or more representative of the fair value of fund investments.”⁴

3. Testing the appropriateness and accuracy of the fair value methodologies that have been selected, including identifying the testing methods to be used and the minimum frequency with which such testing methods are to be used.
4. Overseeing and evaluating any pricing services used, including establishing the process for approving, monitoring and evaluating each pricing service provider and initiating price challenges.⁵

Valuation designee. A fund’s board may choose to designate the fund’s primary investment adviser as its “valuation designee” to perform the fair value determinations of any or all fund investments by carrying out all of the functions required in items 1–4 above, subject to the board’s oversight.⁶ The definition of valuation designee expressly excludes a fund’s sub-adviser.

Oversight and reporting. If a fund’s board designates the fund’s investment adviser as its valuation designee, the Rule requires the board to oversee the investment adviser with respect to its fair value determinations, and the investment adviser is required to:

1. Inform the board in writing of the titles of the persons responsible for determining the fair value of the fund’s portfolio holdings, including the particular functions for which they are responsible and any material changes to the roles or functions of these persons.
2. Reasonably segregate fair valuations from the fund’s portfolio management “such that the portfolio manager(s) may not determine, or effectively determine by exerting substantial influence on, the fair values ascribed to portfolio investments.”⁷
3. At least quarterly, provide the board in writing with any reports or materials requested by the board related to the fair value of the fund’s investments or the investment adviser’s process for fair valuing fund investments, as well as a summary or description of material fair value matters that occurred in the prior quarter, including: (a) any material changes in the assessment and management of valuation risks, including material changes in conflicts of interest of the investment adviser (and any other service provider), (b) any material changes to, or material deviations from, the fair value methodologies employed and (c) any material changes to the process for selecting and overseeing pricing services, as well as any material events related to the investment adviser’s oversight of pricing services.
4. At least annually, provide the board in writing with an assessment of the adequacy and effectiveness of the investment adviser’s process for determining the fair value of the designated portfolio of investments, including (a) a summary of the results of the testing of fair value methodologies employed and (b) an assessment of the adequacy of resources allocated to the process for determining the fair value of the fund’s investments, including any material changes to the roles or functions of the persons responsible for determining fair value.⁸
5. Notify the board of the occurrence of matters that materially affect the fair value of the fund’s investments, including any significant deficiency or material weakness in the effectiveness of the investment adviser’s fair value determination process or material errors in the calculation of a fund’s NAV (each a “material matter”), within five business days after the adviser becomes aware of the material matter (or shorter period determined by the board), along with timely follow-on reporting as the board may determine to be appropriate.⁹ According to the Release, this “standard is similar to that of ‘material compliance matter’ found in rule 38a-1.”¹⁰

Recordkeeping. The Release simultaneously adopts companion Rule 31a-4 regarding records related to fair value determinations.¹¹ Rule 31a-4 requires an investment adviser to maintain “appropriate” documentation to support its fair value determinations, as well as the various periodic reports to a fund’s board described above.¹² Existing Rule 31a-2 already requires a fund to maintain “all schedules evidencing and supporting each computation of net asset value of the investment company shares.” However, the Release states that “[w]hile some records currently required to be maintained . . . may be the appropriate documentation to support fair value determinations in some circumstances, they may not always be sufficient to meet that standard.” The Release also acknowledged that a separate recordkeeping rule would ensure that a recordkeeping failure does not mean that a board has not fair valued in good faith.

Definition of “readily available.” Under Section 2(a)(41) of the 1940 Act, if a market quotation is “readily available” for a portfolio holding, it must be valued at its market value. If market quotations are not readily available, a holding’s value is its “fair value as determined in good faith by the board.” However, the term “readily available” was not previously defined in the 1940 Act or rules thereunder. To fill this gap, the Rule provides:

For purposes of section 2(a)(41) . . . 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.

The Release notes that ASC Topic 820 defines level 1 inputs as “[q]uoted prices (unadjusted) in active markets for identical assets . . . that the reporting entity can access at the measurement date” and states that the Rule’s definition

is consistent with the definition of a level 1 input in the fair value hierarchy outlined in U.S. GAAP. Thus, under the final definition, a security will be considered to have readily available market quotations if its value is determined solely by reference to these level 1 inputs. Fair value, as defined in the Act and further defined in rule 2a-5, therefore must be used in all other circumstances.

Thus, for purposes of the Rule, for a quotation to be “readily available,” a security’s value must be determined solely by reference to level 1 inputs under U.S. GAAP. The Release specifically states that evaluated prices, indications of interest and accommodation quotes would not be “readily available market quotations” for purposes of the Rule. The Release notes that whether a market quotation would be “unreliable” is also informed by U.S. GAAP, noting that “we will generally presume that a quote would be unreliable under [the Rule] 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.”

Additionally, the Release states that the Rule’s definition of readily available market quotations will apply in all contexts under the 1940 Act and the rules thereunder, including Rule 17a-7. The Release recognizes that, as a result, certain transactions that could formerly have been effected in reliance on Rule 17a-7 may no longer be deemed to have readily available market quotations and, therefore, may not be eligible for trading in reliance on Rule 17a-7. The Release cites certain SEC staff no-action letters that permitted transactions involving municipal fixed-income securities in reliance on Rule 17a-7 where market quotations were not readily available and the transaction was effected at a

price provided by an independent pricing service.¹³ The Release goes on to state that the SEC staff is “reviewing these letters to determine whether these letters, or portions thereof, should be withdrawn [and] [s]eparately, consideration of potential revisions to rule 17a-7 is on the rulemaking agenda. We welcome input from the public as we undertake our consideration of rule 17a-7.”

Unit investment trusts. The Rule provides that, if the initial deposit of portfolio securities into a UIT occurs after the Rule’s effective date, the UIT’s trustee or depositor is responsible for carrying out the requirements to determine fair values in good faith (i.e., items 1–4 above). If the initial deposit occurs before the Rule’s effective date, and an entity other than the fund’s trustee or depositor has been designated to carry out the fair value determinations, that entity must carry out those requirements.

Board oversight. The Release provides extensive guidance on board oversight of the fair value determination process where it designates a valuation designee under the Rule. Following are selected excerpts:

Where 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.

Boards should approach their oversight of the performance of fair value determinations by the valuation designee of the fund with a skeptical and objective view that takes account of the fund’s particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determination process, and the skill and resources devoted to it.

The board should view oversight as an iterative process and seek to identify potential issues and opportunities to improve the fund’s fair value processes.

We expect that boards engaged in the process would use the appropriate level of scrutiny based on the fund’s valuation risk, including the extent to which the fair value of the fund’s investments depend on subjective inputs. . . . As the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, we expect that the board’s level of scrutiny would increase correspondingly.

[C]onsistent with their obligations under the Act and as fiduciaries, boards should seek to identify potential conflicts of interest, monitor such conflicts, and take reasonable steps to manage such conflicts.

Boards should probe the appropriateness of the valuation designee’s fair value processes. In particular, boards should periodically review the financial resources, technology, staff, and expertise of the valuation designee, and the reasonableness of the valuation designee’s reliance on other fund service providers, relating to valuation.

Boards should also consider the type, content, and frequency of the reports they receive . . . While a board can reasonably rely on the information provided to it in summaries provided by the valuation designee and other service providers in conducting appropriate oversight, 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. Further, if a board becomes aware of material matters . . . we believe that in fulfilling its oversight duty the board must inquire about such matters and take reasonable steps to see that they are addressed.

EFFECTIVE AND COMPLIANCE DATES

Rules 2a-5 and 31a-4 become effective 60 days after publication of the Release in the Federal Register.¹⁴ The compliance date will be eighteen months following the effective date. The Release provides that funds will have the option of complying with the Rules before the compliance date once the Rules become effective. However, to promote regulatory consistency, the Release states that any fund that elects to rely on Rules 2a-5 and 31a-4 before the compliance date may rely only on those rules, and may not also rely on other SEC guidance and staff letters and other guidance that will be withdrawn or rescinded on the compliance date.

In addition, on the effective date, the SEC will rescind ASRs 113 and 118, various no-action letters and staff guidance identified in the Release, as well as the “Last paragraph of Section III.D.2.(a) and the entirety of Section III.D.2.(b) of the 2014 Money Market Fund Release”¹⁵ and “Valuation Guidance Frequently Asked Questions (FAQ 1 only).” The rescinded portions of the [2014 Money Market Fund Release](#) and [FAQ 1](#) contain the SEC and SEC staff’s identical assertions that “a fund’s board of directors has a non-delegable responsibility to determine whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund’s portfolio security.”

OBSERVATIONS

Readily available market quotation definition. The Release states that the Rule’s definition of readily available market quotations will apply in all contexts under the 1940 Act and the rules thereunder, including Rule 17a-7. As noted in the Release, “[f]or a fund to engage in a cross trade under Rule 17a-7, the security first must have a ‘readily available market quotation’ and then the transaction must meet the other conditions of that rule.” As noted above, the Release also indicates that evaluated prices, indications of interest and accommodation quotes would not be “readily available market quotations” for purposes of the Rule. This suggests that – depending on further guidance from the SEC, including the results of the SEC’s review of the line of no-action letters permitting transactions effected at prices provided by independent pricing services and any revisions to Rule 17a-7 – funds may no longer be able to effect cross trades in most fixed income securities in reliance on Rule 17a-7 beginning no later than the Rule’s compliance date. This would have a major impact on the current cross trading practices of many fund complexes.

Separately, through a line of no-action letters,¹⁶ the SEC staff has permitted various affiliated persons, at least one of which is a fund, to effect in-kind transactions in which transferred securities are valued identically by the participants for purposes of determining their NAVs (such that neither participant experiences an artificial loss or gain simply due to different valuation procedures). The no-action letters did not exclude securities that were valued for NAV purposes based upon independent pricing services from being transferred in these transactions, and the industry has not interpreted the no-action letters as containing such an exclusion. It is not obvious why pricing service prices may be relied upon by funds in these affiliated transactions but not in Rule 17a-7 transactions.

Changes in selected methodology. The Rule provides that a fair valuation methodology may be changed “if a different methodology is equally or more representative of the fair value of fund investments.” (Emphasis added). In some cases, it may be difficult to conclude with any certainty

that a new method will be at least as representative of fair value as its predecessor. The wording of the Rule suggests that, if a new methodology proves inferior, the determinations based on the new methodology could be deemed a violation of the Rule. The Release draws on ASC Topic 820-10--5-25, which the SEC describes as “requiring consistent application of valuation techniques, but providing that a change in a valuation technique . . . is appropriate if the change results in a measurement that is equally or more representative of fair value.” It is not clear whether a reasonable determination at the time a methodology is changed suffices and avoids ex post criticism and even strict liability.

Segregation of portfolio management personnel. The Release added text to the segregation requirement to clarify that the segregation of portfolio management staff is intended to prevent portfolio managers from exerting undue influence on the fair values ascribed to portfolio investments. Nonetheless, the SEC recognized in the Release that portfolio managers can participate “in the process of fair value determinations because of the unique insights that portfolio management may have regarding the value of fund holdings.” Permitting portfolio management to participate in fair valuations, while assuring that that participation does not amount to substantial influence may be difficult, especially if judged in hindsight. This is may be an area where the industry will want to seek clarification from the SEC staff.

Significant deficiency or material weakness. In 2007, following a directive of the Sarbanes-Oxley Act, the SEC adopted a [release](#) in which it defined, for purposes of Regulation S-X, the terms “significant deficiency” and “material weakness.” The Rule requires an investment adviser to notify a fund’s board of the occurrence of matters that materially affect the fair value of the fund’s investments, including any significant deficiency or material weakness in the effectiveness of the investment adviser’s fair value determination process (“material matter,” which the Release states is a standard “similar to that of ‘material compliance matter’ found in rule 38a-1”), and the Release notes that material matters under the Rule “would generally include, for example, material weaknesses and significant deficiencies as defined in [Regulation S-X] that are related to fair value determinations.”

Both defined terms in Regulation S-X concern internal controls over financial reporting and underlie Rules 30a-2 and 30a-3 under the 1940 Act. However, it remains unclear how accounting rules, which apply in the context of preparing financial reports and to a discrete set of fund holdings at the end of a financial reporting period over a period of up to 60 days, translate to the daily calculations of the fair value of a significantly greater number of fund holdings over a much shorter time horizon.¹⁷ At a minimum, the expertise of individuals performing daily fair value determinations may differ from the expertise of individuals preparing financial reports and assuring compliance with Rules 30a-2 and 30a-3.

A requirement, not a safe harbor. While perhaps less prescriptive than the SEC’s recent liquidity risk management and derivatives risk management rules, the Rule imposes a mandatory, minimum framework for fair valuations. Many commenters had recommended that the proposed rule be recast as a non-exclusive safe harbor or otherwise be reworked to provide greater flexibility but, in rejecting these recommendations, the Release notes that it was “important to establish a minimum and consistent framework for fair value practices across funds.” While the Rule was unanimously approved by the SEC’s commissioners, Commissioner Hester M. Peirce issued a statement observing that “[a]long with many commenters, I see value in allowing fund boards the freedom to tailor their valuation assessment processes to their funds’ individual needs and circumstances by redrawing the provisions of rule 2a-5 as a non-exclusive safe harbor” and that “[t]he prescriptive nature of the rulemaking could stifle fund boards’ and advisers’ initiative and innovation.”

Fair value policies and procedures. Although the Rule omits the specific provisions in the

proposing release that would have separately required that a fund adopt written policies and procedures addressing the determination of fair value, funds and investment advisers will still need to consider changes to existing fair value policies and procedures that are reasonably designed to prevent violation of Rules 2a-5 and 31a-4. The Release notes that, because Rules 2a-4 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 fair value policies and procedures must be approved by the board pursuant to Rule 38a-1.

Determining when a market quotation is no longer reliable. As adopted, the Rule changed a requirement in the proposing release to the effect that a fair valuation program must include "criteria for determining when market quotations are no longer reliable." To explain this change, the Release states that "to satisfy the requirement to monitor for circumstances that may necessitate the use of fair value . . . boards and valuation designees would have to take into account the circumstances that may cause market quotations to be no longer reliable." In addition, the Release notes that requiring, in advance, "a list of specific criteria for determining when market quotations may no longer be reliable could limit the board's or valuation designee's flexibility."

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If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney contacts.

1. The Release also includes new Rule 31a-4 under the 1940 Act, which addresses recordkeeping requirements relating to the Rule.
2. The Rule provides that "board" means either the fund's entire board of directors/trustees or a designated committee composed of a majority of directors/trustees who are not interested persons of the fund.
3. In a change from the proposing release, a fund's board may not assign fair value determinations to one or more sub-advisers. As adopted, the Rule permits a board to designate, as its "valuation designee," (i) the fund's adviser or (ii) if the fund does not have an investment adviser, an officer or officers of the fund. The definition of valuation designee expressly excludes a fund's sub-adviser. The second option is available only to an internally managed fund. In this Alert, we assume that a board's valuation designee will be the fund's primary investment adviser. Unit investment trusts ("UITs"), which do not have a board or an investment adviser, normally rely on the trustee or depositor to perform fair value functions and, as discussed below, are treated separately under the Rule.
4. This is a change from the proposing release, which did not include the proviso. In another change from the proposing release, the Release omits a requirement that would have required the board or investment adviser to consider the applicability of the selected fair value methodologies to types of investments a fund does not currently own but in which the fund intends to invest.
5. This is a change from the proposing release, which would have required a fund to adopt and implement written policies and procedures addressing the determination of the fair value of fund investments that are reasonably designed to achieve compliance with the requirements described in items (1)-(4). The Rule does not include this requirement. In the Release, the SEC recognized that, with the adoption of the Rules 2a-5 and 31a-4, Rule 38a-1 would require the adoption and implementation of written policies and procedures reasonably designed to prevent violations of the Rule's requirements.
6. The Rule provides that a board may "designate" a valuation designee (to perform fair value determinations), which is a change from the proposing release's use of the word "assign." In the Release, the SEC stated that "[s]ome commenters believed that the term 'assign' could suggest

that the board has completely delegated the entire valuation function and related obligations to the adviser.” For internally managed funds, which do not have an investment adviser, the definition of valuation designee permits an officer or officers of the fund to be the valuation designee. In this Alert, we assume that a board’s valuation designee will be the fund’s primary investment adviser.

7. In a change from the proposing release, the Release added the quoted text because the Release simultaneously deleted “process of making,” which preceded “fair market valuations.” In the Release, the SEC recognized that portfolio managers may have “unique insights . . . regarding the value of fund holdings” and, therefore, limited the segregation requirement to focus on undue influence. The Release indicates that ascribing fair values to portfolio investments based solely on information provided by the portfolio manager would not satisfy the segregation requirement.
8. The Rule requires that these items be reported annually to a board. This is a change from the proposing release, which would have required quarterly reports of these items. In another change from the proposing release, the Rule clarifies that the annual assessment may contain a summary of testing results and removes a requirement, which appeared in the proposing release, to report service provider changes or price overrides as per se material events related to the investment adviser’s oversight of pricing services.
9. This is a change from the proposing release, which specified a maximum of three business days instead of five. The Release acknowledges that the materiality of some matters may not be immediately apparent. The Release provides that the valuation designee should promptly determine the materiality of matters it identifies consistent with its fiduciary duties and then notify the board within five business days after determining that the matter is material. If a valuation designee has not been able to determine a valuation matter’s materiality after 20 business days of becoming aware of the matter, the Release indicates that the SEC would expect the designee to then notify the board of its ongoing evaluation of the matter within five business days.
10. The Release states that material matters in this context would generally be matters about which a fund board “would reasonably need to know in order to exercise appropriate oversight of the valuation designee’s fair value determination process,” including matters that “could have materially affected” the fair value of the fund’s investments.
11. In a change from the proposing release, the Release does not specify the newly required records in the text of the Rule. Instead, the SEC adopted Rule 31a-4. If a fund’s board does not designate a valuation designee, the fund is required to maintain the appropriate documentation to support its fair value determinations.
12. In another change from the proposing release, the Release 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. However, consistent with the proposing release, the Release states that “the requirement to maintain appropriate documentation to support fair value determinations should include documentation that would be sufficient for a third party, such as the [SEC] staff, not involved in the preparation of the fair value determinations to verify, but not fully recreate, the fair value determination.”
13. See, *e.g.*, United Municipal Bond Fund, SEC No-Action Letter (pub. avail. Jan. 27, 1995) and Federated Municipal Funds, SEC No-Action Letter (pub. avail. Nov. 20, 2006).
14. As of the date of this Alert, the Release has not been published in the Federal Register.
15. Money Market Fund Reform; Amendments to Form PF, Rel. No. IC-31166 (Jul. 23, 2014) (“2014 Money Market Fund Release”).
16. See, *e.g.*, Signature Financial Group, Inc., SEC no-action letter (pub. avail. Dec. 28, 1999) and GE Institutional Funds, SEC no-action letter (pub. avail. Dec. 21, 2005).
17. A similar observation was made in the ABA Comment Letter, which was cited in the Release.

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