



A Robinson+Cole Legal Update

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Fund Valuations – A New Way to Keep Score

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The Securities and Exchange Commission (SEC) recently voted to propose a new Rule 2a-5 under the Investment Company Act of 1940 (1940 Act), which would provide for a new framework for funds' fair value determinations when a market value is not readily available (Proposed Rule) [1]. Under Section 2(a)(41)(B) of the 1940 Act, "fair value" is defined as valuations "determined in good faith by the board of directors." The Proposed Rule would also define "readily available" market quotations for purposes of the 1940 Act. The Proposed Rule is meant to clarify how fund boards can satisfy their valuation obligations, and would apply to open- and closed-end funds as well as business development companies. [2]

Fair Value Determinations under the Proposed Rule

Under the Proposed Rule, any determination of fair value in good faith would involve:

- Identifying and Managing Material Valuation Risks and Conflicts of Interest – The Proposed Rule would mandate an assessment of the material risks and material conflicts of interest that could affect a particular fair value determination and the implementation of a fair value decision-making process that manages those risks and conflicts of interest. [3]
- Establishing and Testing Fair Value Methodologies – The Proposed Rule would require, among other things, determining the key inputs and assumptions specific to the fair valuation of each asset class or portfolio holding and the methodologies that will apply to new types of investments in which the fund intends to invest. The Proposed Rule would also require that the selected methodologies be consistently applied and periodically reviewed for appropriateness and accuracy, and that they are to be adjusted if necessary. The Proposing Release states that "for a fair value methodology to be appropriate under the [Proposed Rule], it must be determined in accordance with U.S. GAAP." The SEC noted that the tests to be performed, and the frequency with which they should be administered, are facts and circumstances dependent with respect to a fund and thus should be determined by the fund's board or adviser. The Proposed Rule, however, would require the identification of both the specific testing methods to be used and the minimum frequency of the testing.
- Establishing a Process for the Approval, Monitoring and Evaluation of Pricing Services and Other Third-Party Vendors – The Proposed Rule would require a substantive process for approving the use of a pricing service and the ongoing monitoring and periodic evaluation of the pricing service. The Proposed Rule would also require a board or a delegated adviser to establish criteria for when, and a process for how, a vendor price is challenged.
- Policies and Procedures – While the Proposed Rule would mandate written compliance policies and procedures specific to new Rule 2a-5, the Proposing Release acknowledges that Rule 38a-1 under the 1940 Act would apply to a fund's obligations under the Proposed Rule, and to the extent that an adviser's policies and procedures under the Proposed Rule "would otherwise be duplicative of fund valuation policies under Rule 38a-1, a fund could adopt the [R]ule 2a-5 policies and procedures of the adviser in fulfilling its Rule 38a-1 obligations." [5]
- Maintaining Certain Records, including Appropriate Documentation to Support Fair Value Determinations – The Proposed Rule would require the retention of appropriate documentation to

support fair value determinations, including information regarding the specific methodologies applied and the assumptions and inputs considered when making fair value determinations for at least five years from the time the determination was made, the first two years in an easily accessible place and a copy of the fair value policies and procedures that are in effect, or were in effect at any time within the past five years, in an easily accessible place.

“Readily Available Market Quotations”

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 the market value, but where market quotations are “not readily available,” the holding’s value must be fair-valued as determined in good faith by the fund’s board. The Proposed Rule would provide that 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 Proposing Release states that a “quote would be considered unreliable under proposed [R]ule 2a-5(c) in the same circumstances where it would require adjustment under U.S. GAAP or where U.S. GAAP would require consideration of additional inputs in determining the value of the security.” [6]

The Proposing Release reiterates the SEC’s current view that evaluated prices are not, by themselves, readily available market quotations. The same would be true for “indications of interest” and “accommodation quotes.” As discussed below, this has implications for the use of evaluated prices provided by pricing services, most typically for bonds and other over-the-counter instruments, in other contexts.

Delegation to Advisers

The Proposed Rule specifically allows boards to assign responsibility for fair value determinations to the fund’s adviser (or one or more sub-advisers), subject to board oversight and certain reporting, recordkeeping and other conditions designed to allow the board to effectively oversee the adviser’s fair value determinations. An adviser assigned fair valuation responsibilities would carry out such responsibilities in accordance with the requirements set forth above, subject to the following additional conditions:

- *Board Oversight.* At least quarterly, the adviser would be required to provide a written assessment of the adequacy and effectiveness of the adviser’s process for determining fair value. Such report would be required to include, among other things, a description of the assessment and management of material valuation risks, including material conflicts of interest.
- *Prompt Reporting.* The adviser would be required to promptly (i.e., no later than three business days after the adviser becomes aware of the matter) report to the board in writing on matters associated with the adviser’s process that materially affect or could have materially affected the fair value of the fund’s investments. This would include a significant deficiency or material weakness in the design or implementation of the adviser’s fair value process or material changes in the fund’s valuation risk.
- *Specification of Responsibilities and Reasonable Segregation.* The adviser would be required to specify the titles of any persons responsible for fair value determinations as well as specify the particular functions for which such persons are responsible, and to reasonably segregate the fair value determination process from portfolio management to avoid conflicts. The Proposing Release noted that a fund should consider the extent of influence that a portfolio manager may have on the administration of the fair value process “and seek to provide independent voices and administration of the process as a check on any potential conflicts of interests to the extent necessary.” [7]
- *Recordkeeping.* The fund would be required to maintain additional records relevant to the assignment.

Rescission of Prior SEC and Staff Guidance

Upon adoption of the Proposed Rule, the SEC would rescind ASR 113 and 118, each of which provides guidance on the role of a fund’s board in fair value determinations, as well as guidance on certain accounting and auditing aspects of valuation. The rescission of such guidance would eliminate the requirement for the independent auditor to verify all quotations of securities with readily-available market quotations at the balance sheet date. According to the Proposing Release, due to developments in the Financial Accounting and Standards Board accounting standards, “fund-specific accounting guidance for

recognition, measurement, and disclosure provided in those statements may no longer be necessary.” Relatedly, SEC staff letters addressing a board’s role in the fair valuation process and other matters covered by the Proposed Rule would also be withdrawn.

Timeline and Comment Period

The SEC proposed a one-year transition period for the Proposed Rule. Comments on the Proposed Rule are due on or before July 21, 2020.

Some Key Takeaways

The Proposed Rule reflects the SEC’s acknowledgment of the current state of the fund industry with respect to portfolio security valuation by formally proposing to permit fund boards to delegate fair value determinations to the fund’s investment adviser. This reflects an understanding that a fund’s board is, generally, not in the best position to fairly value individual portfolio holdings. The Proposed Rule would require funds to modify their current valuation policies and procedures to address the specific aspects of the adviser delegation and oversight requirements. Similarly, advisers will likely have to modify their own valuation procedures to respond to certain aspects of the Proposed Rule, including the need for “prompt” reporting to the fund’s board as well as the requirement to make personnel designations and descriptions in connection with any delegation of fair-valuation responsibilities. The Proposed Rule would also formalize a board’s responsibility for approval of pricing vendors, which may result in greater scrutiny and input into the methodologies used by those vendors.

Finally, the Proposed Rule’s definition of “readily available market quotations” and the discussion in the Proposing Release of evaluated prices may portend future changes to Rule 17a-7 and the conditions around registered funds’ ability to cross-trade fixed income securities.

This update does not purport to be a comprehensive summary of all of the compliance obligations to which advisers are subject; If you have any questions, please contact the author, [Shant Chalian](#), or another member of Robinson+Cole’s [Investment Management Group](#).

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ENDNOTES

[1] The SEC release can be found [here](#) (Proposing Release).

[2] With respect to unit investment trusts (UIT), because such entities do not have a board of directors or an investment adviser, the Proposed Rule would permit the trustee of a UIT to conduct fair-value determinations.

[3] Other than identifying material conflicts of interest, the Proposed Rule does not identify the specific valuation risks to be addressed, but does include a non-exhaustive list of the types or sources of valuation risks (e.g., the proportion of the fund’s investments that are fair-valued, and their contribution to the fund’s returns).

[4] See Proposing Release at 58.

[5] Id. at 27.

[6] Id. at 58.

[7] Id. at 54.





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