Snapshot

SEC adopts fund valuation framework

December 18, 2020
Snapshot 2020-30

The SEC issued a Final Rule, *Good Faith Determinations of Fair Value*, which adopts new Rule 2a-5 under the Investment Company Act of 1940 (the Act), providing a regulatory framework for fund valuation practices.

Rule 2a-5 is designed to clarify how boards of directors and trustees of unit investment trusts can satisfy their obligation to determine fair value in good faith for a portfolio of investments without readily available market quotations. This clarification is in response to market developments, including increases in the variety of asset classes held by funds and increases in both the volume and type of data used in valuation determinations.

The SEC also adopted new Rule 31a-4 under the Act, which provides recordkeeping requirements associated with fair value determinations for investments without readily available market quotations. In addition, the SEC rescinded certain guidance on the recognition, measurement, disclosure, and auditing of fund investments in Accounting Series Releases 113 and 118.

'Readily available' market quotations

The Final Rule provides 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 the quotation is reliable. This definition is consistent with the definition of a level one input in the fair value hierarchy outlined in U.S. GAAP. Under Rule 2a-5, if a market quotation is readily available for a security, it must be determined at market value. Conversely, if market quotations are not readily available, the security must be determined at fair value in good faith by the board of directors or the valuation designee.

Not 'readily available' market quotations

Under Rule 2a-5, the following market quotations are not considered to be "readily available":

- Securities that are not traded on an active market or are valued using inputs other than quoted prices for the specific security (such as credit spreads)
- Evaluated prices, since they are not based on unadjusted quoted prices from active markets for identical investments
- Indications of interest and accommodation quotes (such as an indication of interest expressed in buying a security that is currently awaiting regulatory approval or during an initial public offering registration)
- Securities that are valued using net asset value (NAV) as a practical expedient, such as certain private funds, since their value is not based on unadjusted quoted prices

Pooled investment securities that publish NAV daily

An investment in a mutual fund or similar structure with a readily determinable fair value per share that is determined and published and is used as the basis for current transactions, such as a daily NAV for mutual fund shares, is generally considered to have observable level one inputs under U.S. GAAP. Accordingly, such investments are generally consistent with the definition of "readily available" market quotations under Rule 2a-5.

Fair value determined in good faith

Rule 2a-5 requires the performance of certain functions to determine in good faith the fair value of a fund's investments, including the following:

- Periodically assessing material risks, including material conflicts of interest, and managing identified valuation risks associated with fair value determinations
- Establishing and applying fair value methodologies, including selecting the appropriate fair value methodologies in light of the material valuation risks identified and monitoring for circumstances that may necessitate the use of fair value
- Testing the fair value methodologies for appropriateness and accuracy, including identifying the testing methods to be used and the minimum frequency for using such testing methods
- Overseeing and evaluating any pricing services used, including establishing a process for initiating price challenges as appropriate

Examples of valuation risk

The assessment and management of material valuation risks help promote an effective overall process for determining the fair value of a fund's investments in good faith. In addition, a fund's specific valuation risks depend on the facts and circumstances of the particular fund's investments. Rule 2a-5 provides the following non-exhaustive list of sources and types of valuation risks that valuation designees may consider in determining in good faith the fair value of a fund's investments:

- The types of investments held or intended to be held by the fund and the characteristics of those investments
- Potential market or sector shocks, dislocations, and other types of disruptions that may affect a valuation designee's or third party's ability to operate
- The extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the valuation designee
- The proportion of the fund's investments that are determined at fair value in good faith and their contribution to the fund's returns
- Reliance on service providers that have more limited expertise in relevant asset classes, the use of fair value methodologies that rely on inputs from third-party service providers, and the extent to which third-party service providers rely on their own service providers
- The risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly

Performance of fair value determinations

Under the Act, the fair value of securities and assets without readily available market quotations is determined in good faith by a fund's board of directors. Rule 2a-5 confirms that a board can make this determination or may designate the performance of fair value determinations for any or all of the fund's investments to a "valuation designee," subject to additional conditions and oversight requirements.

Who qualifies as a designee

The valuation designee may be the fund's investment adviser or, if the fund is internally managed, an officer of the fund. However, because a unit investment trust (UIT) does not have a board of directors or an investment adviser, Rule 2a-5 requires a UIT's trustee or depositor to determine fair value in good faith.

If the board of directors designates the determination of fair value to a valuation designee, certain additional requirements apply, including

- Board oversight of the valuation designee;
- Periodic and prompt notification and reporting by the valuation designee to the board regarding the designee's performance of its responsibility and matters that materially affect the fair value of investments, such as any material changes in the assessment and management of valuation risks, any material changes to or deviations from the fair value methodologies, and any material changes to the valuation designee's process for selecting and overseeing pricing services among others; and
- Clear specification of the titles and functions of the persons responsible for fair value determinations by the valuation designee and reasonable segregation of duties among the designee's personnel.

Recordkeeping requirements

Rule 31a-4, which applies to both registered investment companies and business development companies, requires funds or their advisers to maintain appropriate documentation to support fair value determinations. In cases where the board has designated the performance of fair value determinations to a valuation designee, the reports and other information provided to the board must include a specified list of investments or investment types that were designated to the valuation designee.

Appropriate documentation to support fair value determinations

Under Rule 31a-4, funds or their advisers are required to maintain appropriate documentation to support fair value determinations such as the following:

- *When a pricing service is used, records related to the fund or valuation designee's initial due diligence investigation for selecting a pricing service, as well as records from its ongoing monitoring and oversight of the pricing services:* The due diligence should consider the valuation methods or techniques, inputs, and assumptions used by the pricing service for different classes of holdings, and how they are affected as market conditions change, among other matters.
- *Workpapers created by the valuation designee while overseeing pricing services or testing fair value methodologies:* Workpapers include those documenting how the valuation designee monitors and conducts price challenges, analyzes "stale" prices, and performs calibration or back-testing.

Investments with level three inputs would typically require different and more extensive documentation than an investment valued with only level two inputs, depending on the subjectivity of the inputs used in determining fair value.

Retention period for documentation

Under Rule 31a-4, funds and advisers are generally required to maintain the records for six years.

Rescission of certain existing guidance

The SEC also rescinded the guidance in Accounting Series Releases 113 and 118, which include guidance on the recognition, disclosure, and auditing of investment securities. This guidance is superseded or made redundant by the adoption of Rule 2a-5 and by the requirements under existing accounting and auditing standards.

Effective date

Rules 2a-5 and 31a-4 are effective 60 days after publication in the *Federal Register* and will have a compliance date 18 months following the effective date. A fund may voluntarily comply with the rules before the compliance date or after the effective date under certain conditions.

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