SEC Final rule 2a-5 – Good faith determinations of fair value

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Background

On December 3, 2020, the SEC announced adoption of rule 2a-5 (the “Rule”), largely as proposed with a few modifications incorporating certain feedback received from 60+ comment letters. The Rule directly applies to registered investment companies and business development companies, and establishes a consistent, principles-based framework for boards of directors to use in creating their own specific processes in order to determine fair values in good faith. The SEC determined an update to the Investment Company Act (which had last been amended in 1970) was needed to account for new regulatory developments (including the adoption of ASC 820, Fair Value Measurement) and the increasingly complex nature of investments held by public funds. While the ultimate responsibility of compliance with the Rule’s requirements rests with the board of directors, the Rule allows the board to designate the performance of fair value determinations to a “designee”, provided that such designee has a fiduciary duty to the fund such as the fund’s adviser or an officer of an internally managed fund.

Key provisions

The Rule is comprised of two main areas:

1. The specific requirements that must be performed to determine fair values in good faith, which include:
   - Assessing and managing valuation risks;
   - Establishing and applying fair value methodologies;
   - Testing fair value measurements for appropriateness and accuracy; and
   - Monitoring and evaluating pricing services used.
2. The oversight responsibilities of the board should it choose to designate the performance of fair value determinations to a designee, which include:
   - Actively overseeing the valuation designee, which involves scrutinizing the information received, asking probing questions, reviewing the designee’s resources, and identifying and managing conflicts of interest of the designee; and
   - Receiving reporting from the designee on a quarterly basis for any material changes in valuation risks or valuation methodologies used, and on an annual basis for an assessment of the adequacy and effectiveness of the designee’s valuation process.

As part of the finalization of the Rule, the SEC separated the proposed recordkeeping requirements to new rule 31a-4, confirming that a failure to keep required records would not automatically imply that the board had not determined fair value in good faith. In addition, the SEC amended the required time period to maintain appropriate documentation to support fair value determinations to six years (in an easily accessible place for the first two years). The SEC reiterated that if the board designates fair value determinations, the valuation designee (not the fund) would be required to maintain such records.

Implications

The SEC acknowledges that funds' current fair value practices are generally consistent with the requirements of the final Rule. Nevertheless, the SEC also acknowledges that there is variation in funds' fair value processes and the practices of certain funds may be more or less extensive than the requirements of the Rule. As such, the final Rule is likely to have an impact on funds' valuation policies and procedures, whether big or small. Below, we have highlighted the main takeaways from the final Rule and outlined our initial observations as to how funds may be impacted:

Inclusion of Level 2 securities in "Fair Valued" population

The Rule bifurcates securities into those *with* readily available market quotations and those *without* readily available market quotations (which are fair valued as determined in good faith). The SEC states that this definition of readily available market quotations is consistent with the definition of a level 1 input under ASC 820, Fair Value Measurement, and therefore, all other investments should be fair valued in good faith.

- A market quotation is "readily available" only when the "quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date."

Reasonable segregation of functions

The Rule mandates the reasonable segregation of functions of the portfolio manager and those responsible for determining fair values. While portfolio managers may provide inputs used in the valuation process, they may not ultimately determine (or significantly influence the determination of) the fair values of the fund's investments.

- Funds should consider additional disclosures in periodic board reporting around investments in which portfolio managers provide inputs used in the process of determining fair value; if such inputs are significant, the board should also consider if additional controls are warranted to prevent portfolio managers from having an undue influence over determined valuations.

Emphasis on consistency of selected fair value methodologies

The Rule states that funds cannot change valuation methods without documenting why the new method is considered equally or more representative of fair value. The spirit of this requirement is to prevent funds from switching from one valuation approach to another in order to produce a desired fair value.

- The Rule allows funds to incorporate different valuation methods within the same asset class, and permits revising valuation methods if circumstances have changed that result in a different methodology serving as a better indication of fair value (e.g., changing from a model-based valuation to a transaction price upon the occurrence of a trade/round of financing).
- Funds may need to enhance their documentation practices to clearly explain the rationale behind changes in fair value methodologies from period to period in cases where a different methodology is deemed appropriate.

New requirement to test fair value methodologies

The Rule requires that funds identify the nature and frequency of tests to be performed over fair value methods, with the objective of periodically assessing chosen methodologies to determine whether they remain appropriate or need to be adjusted.

- The Rule references calibration and backtesting as examples of testing approaches but clarifies that the form (and timing) of testing is at the discretion of the board and fund.
- While calibration and backtesting have been touted as "best practices" by regulators, testing of fair value methods historically had not been specifically mandated.

Expanded definition of pricing services

The Rule charges funds with developing a process for approving, monitoring, and evaluating each pricing service used.

- Pricing services are defined as "third parties that regularly provide funds with information on evaluated prices, matrix prices, price opinions, or similar pricing estimates or information to assist in determining the fair value of fund investments."
  - This definition extends beyond simply pricing *vendors* (where many funds have written policies and procedures around approval and monitoring) and would include third-party valuation firms (where oversight and monitoring practices [post selection] are not as well documented).
- Although the Rule no longer requires that funds establish criteria for the circumstances where a price challenge would be initiated, the Rule does require that funds establish a process for initiating such price challenges. Such a process would likely encompass the thresholds for price challenges used by many funds today. Funds should consider the role of static and dynamic thresholds for purposes of monitoring prices and evaluating pricing services.

Focus on active board oversight

The Rule emphasizes that the board cannot take a passive approach to overseeing the valuation designee, and instead needs to be skeptical and objective when conducting its oversight activities (e.g., asking probing questions, requesting follow-up information, identifying conflicts of interest, and resolving identified issues).

- The board's level of scrutiny should positively correlate with the fund's increased use of subjective inputs/assumptions in its valuations.
- Boards should identify any conflicts of interest within the valuation designee, and subsequently monitor them. This includes conflicts of interest that may arise from other service providers used by the valuation designee. The Rule notes that the valuation designee has a duty to disclose its conflicts to the board and should work with the board to ensure these conflicts are managed to the board's satisfaction.
- Boards are required to probe the appropriateness of the valuation designee's fair value process, including reviewing the designee's resources and expertise, and reliance on other service providers.
- Boards may wish to review how board meetings are documented (e.g., minutes) and determine if additional records are needed to evidence their active review of the valuation designee's performance of fair value determinations and compliance.

Prompt reporting of material issues to the board

In order for the board to receive critical information in a timely manner, the Rule requires the valuation designee to report, in writing to the board, on "material matters" *no later than five business days* after identification. The Rule provides the valuation designee 20 business days to determine if the matter is material; if the materiality of the matter is still undeterminable after that period, the designee must report such matter to the board within five business days.

- Material matters include 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 NAV.
- Although the SEC declined to establish a specific standard as to what constitutes materiality, the Rule acknowledges that relying upon the "NAV error threshold" ($0.01 a share or 0.5% of the NAV) as the threshold for prompt reporting would not be unreasonable.
- Given the short reporting window, boards and valuation designees may wish to consider developing guidelines in determining if different potential matters would qualify as material and therefore warrant disclosure to the board. Boards may wish to discuss with their auditors what constitutes a material matter for audit purposes to help inform them as they develop these guidelines.

Other provisions

In adopting final Rule 2a-5, the SEC rescinded ASR 118 in its entirety. ASR 118 states that auditors of funds should verify all quotations for securities with readily available market quotations. Rescission of ASR 118 may allow fund auditors to apply only PCAOB standards, which would permit sampling and other techniques to verify the value of fund investments. The Rule notes, however, that the fund's board or valuation designee retains the discretion to request that the auditors test the values of 100% of investments with a readily available market quotation. Furthermore, the Rule clarifies that the rescission of ASR 118 would not affect the SEC's ability to bring enforcement actions against funds that value odd-lot positions in securities at prices provided by vendors for round-lot quantities when the fund does not have the ability to access that round-lot market price to exit the position.

Final Rule 2a-5 includes a definition of readily available market quotations that may affect the ability of funds to cross trade certain investments. Paragraph (c) of the Rule provides that this updated definition of readily available market quotation is applicable to section 2(a)(41) of the Investment Company Act, and therefore, will apply in all contexts under the Investment Company Act, including rule 17a-7, which currently permits cross trades for level 1 and 2 investments provided such pricing is an "independent current market price." The SEC staff is reviewing historical letters and guidance to determine if such guidance (or portions thereof) should be withdrawn and/or if revisions to rule 17a-7 are necessary.

Final Rule 2a-5 no longer requires the adoption of policies and procedures that are designed to ensure compliance with Rule 2a-5. The SEC removed such provision acknowledging that rule 38a-1 (which requires the fund's board to approve fund policies and procedures, and those of each adviser) would require the adoption and implementation of written policies and procedures designed to prevent violations of Rule 2a-5 and 31a-4.

What's next

Rule 2a-5 and rule 31a-4 will have an effective date of 60 days after being published in the Federal Register (which is expected to occur sometime in Q1 of 2021), and a compliance date of 18 months after the effective date. Funds are permitted to adopt as early as the effective date of the Rule.

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