

Have You Complied with the New Fair Valuation Rules?

The 18-month transition period came to an end on September 8, 2022 for compliance with the SEC's [final rule](#) that created a new framework for fund valuation practices. New Rule 2a-5 under the *Investment Company Act of 1940* (ICA) establishes requirements for determining fair value in good faith. The rule requires a fund board or its valuation designee to assess and manage material risks associated with fair value determinations; select, apply, and test fair value methodologies; and oversee and evaluate any pricing services used. This is a principle-based framework for boards to use to create their own specific processes for making fair value determinations; the final rule does not establish a single approach for fair value determinations. New Rule 31a-4 requires funds to maintain appropriate documentation to support fair value determinations and, where applicable, documentation related to the designation of the valuation designee. The rule also formally defines "readily available" market quotations.

The changes apply to all registered investment companies and business development companies regardless of their classification, e.g., open-end funds and closed-end funds, or their investment objective or strategies, e.g., equity or fixed income, actively managed, or tracking an index.

Background

The ICA requires funds to value their portfolio investments using a security's market value when market quotations are readily available, and—when a market quotation for a security is not readily available—by using the security's fair value, as determined in good faith by the fund's board. The SEC last updated valuation practices in a pair of releases issued in 1969 and 1970, Accounting Series Release (ASR) 113 and 118. Since then, markets and fund investment practices have evolved considerably. Many funds now engage third-party pricing services to provide pricing information, particularly for thinly traded or more complex assets. In addition, significant regulatory and accounting developments have altered how boards, investment advisers, independent auditors, and other market participants address valuation.

Determining Fair Value in Good Faith

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

- Periodically assessing and managing material risks associated with fair value determinations, including material conflicts of interest
- Selecting, applying, and testing fair value methodologies
- Overseeing and evaluating any pricing services used

Valuation Risks

Rule 2a-5 requires periodic assessment of material risks associated with the determination of the fair value of a fund's investments, including material conflicts of interest, and managing those identified valuation risks. The SEC declined to

establish a required minimum frequency—boards can select the most appropriate schedule based on a fund’s unique situation but should consider changes in a fund’s investments, significant changes in a fund’s investment strategy or policies, market events, and other relevant factors. Other than material conflicts of interest, the rule does not identify specific valuation risks to be addressed but includes the following non-exhaustive list:

- The types and characteristics of investments held or intended to be held by the fund
- Potential market or sector shocks or 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 fair valued as determined 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

Fair Value Methodologies

To determine fair value in good faith, a board or designee must establish and apply fair value methodologies that should include the following:

- Select and apply appropriate methodologies
- Periodically review the appropriateness and accuracy of the methodologies selected and make any necessary adjustments
- Monitor for circumstances that may necessitate the use of fair value

Selection & Application

The board or valuation designee must select and apply in a consistent manner an appropriate methodology or methodologies for determining (which includes calculating) the fair value of fund investments. The board or valuation designee must specify the key inputs and assumptions specific to each asset class or portfolio holding. The selected methodologies may be changed if different methodologies are equally or more representative of the investment’s fair value. Any change in methodology must be documented under the applicable reporting requirements.

The final rule also clarifies the general requirement for one methodology per asset class. This guidance is not meant to limit a board or valuation designee from using an appropriate methodology even if other investments in the same asset class are fair valued using a different appropriate technique. In a change from the proposal, the final rule does not require the specification of methodologies that will apply to new types of investments in which the fund intends to invest. Consider how you can incorporate thought diversity within the board as it relates to fintech, how the bank can help customers save and invest in new ways, and how new customers could see advantages to opening an account.

Applying a methodology consistently is not meant to lock in place a rigid pre-established methodology, but instead to address the risks associated with switching methodologies to achieve a specific outcome.

FASB's Accounting Standards Codification (ASC) 820, Fair Value Measurement, includes valuation approaches, including the market approach, income approach, and cost approach, as well as valuation techniques and methods as ways in which to measure fair value. To be appropriate under the rule, and in accordance with current accounting standards, a methodology used to determine fair value must be consistent with ASC 820 and must be derived from one of these approaches. The SEC acknowledges there is no single methodology for determining an investment's fair value because fair value depends on each investment's facts and circumstances, including the relevant market and market participants.

The SEC is superseding the section on valuing thinly traded securities in the 2014 Money Market Funds Adopting Release.

Appropriate methodologies for funds holding debt securities should generally not fair value these securities at par or amortized cost basis based on the expectation that the fund will hold these securities until maturity, if a fund cannot reasonably expect to receive approximately that value upon the measurement date under current market conditions. Funds may not fair value portfolio securities at prices not achievable on a current basis on the belief that the fund would not currently need to sell those securities.

Periodic Review

An inappropriate methodology, or a methodology that is applied inconsistently, increases the likelihood that a fund's investments will be improperly valued. The final rule requires selected methodologies to be periodically reviewed for appropriateness and accuracy and to be adjusted, if necessary, *i.e.*, based on the results of back testing or calibration. A necessary adjustment to the selected methodology is not limited to modifying an existing method for a particular investment but also may include changing to a new methodology where appropriate.

When to Use Fair Value

The final rule requires the board or valuation designee to monitor for circumstances that may necessitate the use of fair value as determined in good faith. The board has flexibility to consider the full range of conditions that may affect the reliability of market quotations.

Testing of Fair Value Methodologies

The final rule requires the testing of the appropriateness and accuracy of the methodologies used to calculate fair value to ensure that the selected methodologies are appropriate and that any adjustments are made where necessary. The rule requires the identification of the testing methods to be used and the testing's minimum frequency. The framework is flexible; the specific tests and the frequency depend on each fund's circumstances and can be determined by the board or designee. The SEC notes that calibration and back-testing are useful methods to identify any methodology issues; however, these are not required. A fund may use any other appropriate testing method, which may develop and evolve over time.

The SEC specifically rejected a request for a de minimus exception to this requirement.

Oversight of Pricing Services

To obtain valuation information, particularly for thinly traded or more complex assets, pricing services may be used. Pricing services are 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 an investment's fair value.

The SEC's definition of a pricing service is slightly more expansive than the PCAOB definition.

For funds that use pricing services, the board or valuation designee must establish a process for the approval, monitoring, and evaluation of each pricing service provider, considering the following factors:

- Qualifications, experience, and history of the pricing service
- 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
- The quality of the pricing information provided and the extent to which the service determines its pricing information as close as possible to the time of the fund's net asset value (NAV) calculation
- The pricing service's process for considering price challenges, including how the pricing service incorporates information received from pricing challenges into its pricing information
- The pricing service's actual and potential conflicts of interest and the steps to mitigate such conflicts
- The pricing service's testing processes

Pricing Challenges

There may be times when pricing information from a pricing service differs materially from the board's or designee's view of the investment's fair value, and there may be a need to contact the pricing service to question the basis for the pricing information. Funds will be required to establish a process to initiate price challenges that would generally outline the circumstance under which a price challenge should be initiated.

Fair Value Policies & Procedures

The final rule leverages existing requirements in Rule 38a-1. The board must approve a fund's policies and procedures, and those of each adviser and other specified service providers, based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the federal securities laws. The adoption of new Rules 2a-5 and 31a-4 will require the adoption and implementation of new written policies and procedures that must be approved pursuant to Rule 38a-1 and may not be considered material amendments to existing fair value policies and procedures.

Performance of Fair Value Determination

Under the ICA, securities and assets without readily available market quotations are valued at fair value as determined in good faith by a fund's board of directors. The new rule also would permit a board to designate the fair value determinations to a fund adviser or an officer of the fund if the fund is internally managed. The designee would be required to carry out the fair value determination functions described above, and additional requirements would apply, including:

- Board oversight
- Periodic and prompt board reporting
- Clear specification of responsibilities and reasonable segregation of duties among the designee's personnel

The determination of fair value cannot be designated to a sub-adviser; boards can still seek the assistance of sub-advisers or other specialists as they deem appropriate. This may include pricing services, fund administrators, sub-advisers, accountants, or legal counsel. The entity or officer designated to perform fair value determination is still responsible for that determination.

Unit Investment Trusts

Because unit investment trusts (UIT) do not have boards or investment advisers, the final rule permits only the trustee or depositor to determine fair value in good faith for new UITs. Special grandfather provisions are provided to allow enough time for pre-existing UITs to amend trust indentures. If the UIT's initial deposit date (including a rollover) precedes the final rule's effective date, and if the trust indenture designated an entity other than the UIT trustee or depositor to perform fair value determinations, that previously designated entity may continue to perform those duties.

Board Oversight

Where the board assigns fair value determinations to a designee, the rule requires board oversight. Boards should approach this oversight with a skeptical and objective view that considers the fund's particular valuation risks, including conflicts of interest, the appropriateness of the fair value determination process, and the skill and resources devoted to it. This must be an active—not passive—activity. Boards should view oversight as an iterative process and seek to identify potential issues and opportunities to improve the fund's fair value processes. The rule requires the designee to report to the board on matters related to the designee's fair value process, to ensure that the board has enough information for oversight. Boards also should request follow-up information when appropriate and take reasonable steps to see that matters identified are addressed.

Boards are expected to 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, *i.e.*, a fund that invests in publicly traded foreign companies versus a fund that invests in private, early-stage companies. As the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, the board's level of scrutiny should increase correspondingly.

Boards should seek to identify potential conflicts of interest, monitor such conflicts, and take reasonable steps to manage such conflicts. In overseeing the designee's process for making fair value determinations, the board should understand the role of—and inquire about conflicts of interest regarding—any other service providers used by the adviser as part of the process and satisfy itself that any conflicts are being appropriately managed.

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

Boards should consider the type, content, and frequency of the reports received (see the final rule requirements in the next section). Boards can reasonably rely on the information provided to them in summaries and other materials provided by the designee and other service providers in conducting their oversight, but it is incumbent on the board to request and review such information to be fully informed of the designee's process for determining the fair value of fund investments. If the board becomes aware of material matters (whether the board identifies the matter itself or the fund's chief compliance officer (CCO) or adviser or another party identifies the issue), the board must inquire about such matters and take reasonable steps to see they are addressed.

Boards should consider the designee's compliance capabilities that support the fund's fair value processes, and the oversight and financial resources made available to the CCO relating to fair value.

Boards are not required to ratify the fair value determination by the valuation designee.

Board Reporting

Effective information flow is a critical part of a board's oversight of a valuation designee. It is important for the board to receive relevant and tailored information from the valuation designee to ensure that the board has enough insight and data to exercise effective oversight. The rule requires the designee's reports to include such information as may be reasonably necessary for the board to evaluate the matters covered in the reports.

The content of the periodic or prompt reports and supplemental information could take the form of narrative summaries, graphical representations, statistical analyses, dashboards, or exception-based reporting, among other methods.

Periodic Reporting

Quarterly

Mandatory quarterly reporting is limited to issues about which the board has requested information, as well as information about material changes or events that occurred during the period. Material, in this context, would generally be those matters about which the board would reasonably need to know to exercise appropriate oversight of the valuation designee's fair value determination process, for example:

- Significant deficiencies or material weakness in internal controls over financial reporting related to fair value determination
- Material changes to or deviations from methodologies, including changes to critical inputs or assumptions
- A pattern of price challenges or overrides over time that raise concerns about the overall valuation process

Annually

Rule 2a-5 requires the designee, at least annually, to provide the board a written assessment of the adequacy and effectiveness of the designee's process for determining the fair value of the assigned portfolio of investments, testing results, and adequacy of allocated resources. The annual assessment can contain a summary of testing results and there is no longer a requirement to report service provider changes or price overrides.

Prompt Board Notification

The valuation designee must provide a written notification of the occurrence of matters that materially affect the fair value of the investment portfolio no later than five business days after the designee becomes aware of the material matter. Boards can shorten this notification time frame. Such matters include a significant deficiency or material weakness in the design or effectiveness of the designee's fair value determination process or of material errors in the calculation of the NAV.

The SEC declined to set a NAV threshold, but noted it would not be unreasonable to use the industry standard of \$0.01 a share or 0.5 percent of the NAV.

Specification of Functions

To enhance accountability and provide clear lines of responsibility, the valuation designee must specify the titles of the persons responsible for determining the fair value of the designated investments, including the particular function for which the named person is identified. The specific personnel responsible for price challenges should be identified, including those with the authority to override a price, along with the roles and responsibilities of such persons. The designee is required to establish a process for the review of price overrides. To reduce potential conflicts of interest, the designee should reasonably segregate fair value determinations from the fund's portfolio management, such that the portfolio manager may

not determine—or effectively determine by exerting substantial influence on—the fair value ascribed to portfolio investments.

Record-Keeping

New Rule 31a-4 requires that a fund maintain appropriate documentation records to support fair value determinations for at least six years from the time the determination was made; the first two years in an easily accessible place. The documentation should 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. The SEC includes examples of current working papers that would be considered appropriate such as copies of internally developed models, including inputs and assumptions used therein and relevant supporting documentation. The records kept may vary on a variety of factors, including the subjectivity of inputs, e.g., Level 2 or Level 3.

Readily Available Market Quotations

The board's role in the valuation of a portfolio holding for purposes of fair value depends on whether a market quotation is readily available. Under ICA Section 2(a)(41), if a market quotation is readily available for a portfolio holding, it must be valued at the market value. If market quotations are not readily available, the holding's value must be fair value as determined in good faith by the board; however, the term was not previously defined in the ICA.

The SEC has leveraged accounting concepts in ASC 820 to create a new definition. The final rule would treat a market quotation as “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. A quotation is not readily available if it is not reliable. This definition is consistent with the definition of a Level 1 input in the fair value hierarchy outlined in U.S. GAAP. A security will be considered to have a readily available market quotation if its value is determined solely by reference to Level 1 inputs. Fair value, as defined in the ICA, must be used in all other circumstances.

Indications of interest and accommodation quotes are not considered readily available market quotations for the purposes of Rule 2-5(C).

An investment in a mutual fund or similar structure that has a readily determined fair value per share that is determined and published and is the basis for current transactions such as a daily NAV for mutual fund shares is generally considered to have observable Level 1 inputs under U.S. GAAP.

Securities that are valued using NAV as a practical expedient, like certain private funds, do not require disclosure of the level of input in the fair value hierarchy. These securities generally do not have readily available market quotations under the SEC's definition because their value is not based on unadjusted quoted prices.

Certain securities that had been previously viewed as having readily available market quotations and being available to cross trade under Rule 17a-7 may not meet the new definition and would not be available for such trades.

Rescission of Prior SEC & Staff Guidance

The SEC also is rescinding ASR 113 and 118 in their entirety as of the September 8, 2022 compliance date.

Conclusion

FORVIS will continue to follow SEC regulatory developments. If you have questions about these changes, contact one of our professionals today or visit forvis.com.

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