

SEC Adopts New Valuation Rule for Registered Funds and BDCs

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The SEC issued a long-awaited and highly-anticipated adoption of the valuation rule yesterday (Rule 2a-5) for all registered investment companies and BDCs, as well as a new companion rule containing the recordkeeping requirements associated with Rule 2a-5 (Rule 31a-4). The final rules are available [here](#). We have been particularly interested to see how the final valuation rule defines “readily available” market quotations and addresses the prompt board notification requirement for certain valuation issues. While the final valuation rule addresses a number of concerns that have been raised by the industry and reflects the practical realities of the roles of boards and advisers, fund boards still maintain a substantial amount of responsibility over matters related to valuation.

The final rules will be effective 60 days after publication in the Federal Register. The SEC is providing a transition period of 18 months following the effective date for funds to comply with the provisions of the final rules.

Fair Value Determination and Delegation

Fair Value Determination. Substantially as proposed, the final valuation rule sets forth certain functions that a fund board must perform in order to determine the fair value of a fund’s investments in good faith. The final valuation rule requires that the board or valuation designee (discussed more below) select and apply in a consistent manner an appropriate valuation methodology or methodologies. In response to numerous comments, the final valuation rule modifies this selection requirement in three ways:

- specifies that a valuation methodology may be changed if a different methodology is equally or more representative of the fair value of investments;
- does not require the specification of methodologies that will apply to new types of investments in which a fund intends to invest; and
- removes the requirement that criteria be established for determining when market quotations are no longer reliable.

For funds that use pricing services, the final valuation rule requires, as proposed, that the board or valuation designee establish a process for approving, monitoring and evaluating each pricing service provider. In a change from the proposed rule, the final valuation rule only requires that the board or valuation designee establish a *process* for initiating price challenges rather than a *criteria* for initiating price challenges. Many commenters argued that requiring funds to establish specific criteria for price challenges was too rigid, and that price challenges may be based on different data sources and inputs.

Delegation. Most importantly and largely as proposed, the final valuation rule allows a fund board to delegate fair value determinations to a “valuation designee,” subject to board oversight. In a change from the proposed rule, the final valuation rule permits a valuation designee to be either a fund’s adviser (but not a sub-adviser) or, if the fund does not have an adviser, an officer or officers of the fund. Although a sub-adviser may not be a valuation designee, the adopting release does note that the sub-adviser may assist the valuation designee as the designee deems appropriate.

Readily Available Market Quotations

The SEC adopted the definition of readily available market quotations as proposed. The final valuation 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 a quotation will not be readily available if it is not reliable.” The SEC noted that commenters generally supported the proposed definition.

In the adopting release, the SEC noted that a number of commenters raised concerns that the definition of readily available market quotations could prevent funds from engaging in cross trades of Level 2 securities, including certain fixed income securities, if this concept in Rule 17a-7 were interpreted in accordance with the Rule 2a-5 definition. In lieu of addressing this concern, the SEC instead provided an interpretation that the definition of readily available market quotations under Rule 2a-5 will apply in all contexts under the 1940 Act, including Rule 17a-7. The SEC’s release recognizes that some funds will need to conform their practices under Rule 17a-7 to the extent certain securities may no longer be deemed to have readily available market quotations under the new definition and, thus, could not be traded in reliance on Rule 17a-7. The adopting release further states that the staff is currently reviewing staff letters on this topic to determine whether any should be withdrawn, and that the consideration of potential revisions to Rule 17a-7 is on the rulemaking agenda.

Board Oversight and Reporting

Oversight. The final valuation rule, consistent with the proposal, requires a board to oversee its valuation designee. The SEC declined to provide additional guidance on precisely what a board must do to satisfy its oversight requirement. Instead, the SEC reiterated its guidance from the proposing release that the board should view its oversight role consistent with its fiduciary duties and its other obligations under the 1940 Act.

Reporting. The final valuation rule requires that the valuation designee periodically report to the board. In a departure from the proposed rule and in response to comments, the final valuation rule requires that the valuation designee provide quarterly reports to the board that address any issues specifically requested by the board, as well as information about any material fair value matters that occurred during the period. The proposed rule would have required the valuation designee to provide quarterly reports on the entire fair value process, which the valuation designee must instead provide annually under the final valuation rule.

The final valuation rule requires that the valuation designee provide the board with written notification of the occurrence of any matters that materially affect the fair value of the designed portfolio investments within a timeframe determined by the board. In response to comments, the SEC extended the prompt reporting period from three business days to five business days after the valuation designee becomes aware of the matter. In addition, unlike the proposed rule, the final valuation rule requires the valuation designee to provide timely follow-on reports as may be requested by the board. The SEC noted that this modification is meant to facilitate ongoing communications between the board and the valuation designee, which commenters urged was necessary for the board to fulfill its oversight role. Overall, the SEC believes that the final version of the reporting requirement should clarify and focus the prompt reporting requirement and provide boards and valuation designees with more flexibility.

New Rule 31a-4

In addition to the final valuation rule, the SEC adopted a companion Rule 31a-4 that applies to both registered investment companies and BDCs and contains the recordkeeping requirements associated with the valuation rule. Rule 31a-4 will require, substantially as proposed as part of the proposed valuation rule, a fund or its adviser (if the adviser is the valuation designee) to maintain appropriate documentation to support fair value determinations. As proposed, the valuation rule would have specifically required a fund or adviser to keep records of the specific methodologies applied and assumptions and inputs that form the basis of the fair value determinations, which is not part of Rule 31a-4. In another change from the proposal, Rule 31a-4 does not require documentation relating to the specific methodologies applied and the assumptions and inputs considered when making fair value determinations, as the SEC was persuaded by comments that such a requirement would be impractical. When a valuation designee is involved in the valuation process, Rule 31a-4 provides that the required records must also include a specified list of investments and investment types for which the valuation designee has been designated. Finally, Rule 31a-4 requires that these records be maintained for six years instead of five years as initially proposed.

Authors and
Contacts

David Blass
Partner
david.blass@stblaw.com
[+1-202-636-5863](tel:+12026365863)

Rajib Chanda
Partner
rajib.chanda@stblaw.com
[+1-202-636-5543](tel:+12026365543)

Ryan Brizek
Partner
ryan.brizek@stblaw.com
[+1-202-636-5806](tel:+12026365806)

Debra Sutter
Counsel
debra.sutter@stblaw.com
[+1-202-636-5508](tel:+12026365508)

