

# SEC updates regulatory framework for good faith determinations of fair value

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## Abstract

**Purpose** – To explain the new U.S. Securities and Exchange Commission (“SEC”) Rule 2a-5 (the “Fair Value Rule”) under the Investment Company Act of 1940 (the “1940 Act”), which addresses the valuation practices of registered investment companies and business development companies.

**Design/methodology/approach** – Provides an overview of the Fair Value Rule, followed by a more detailed summary of the key provisions, including relevant guidance provided by the SEC in the release adopting the Fair Value Rule.

**Findings** – The Fair Value Rule establishes a specific framework, a standard of baseline practices across funds, and a set of required functions that must be performed in order to determine in good faith the fair value of a fund’s investments for purposes of applying Section 2(a)(41) of the 1940 Act.

**Originality/value** – Practical guidance from experienced investment management lawyers.

**Keywords** US Securities and Exchange Commission (SEC), Investment Company Act of 1940 (1940 Act), Readily available market quotations, Recordkeeping Rule, SEC Rule 2a-5 (Fair Value Rule), Valuation risks

**Paper type** Technical paper

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**O**n December 3, 2020, the U.S. Securities and Exchange Commission (the “SEC”) voted to adopt new Rule 2a-5 (the “Fair Value Rule”) under the Investment Company Act of 1940 (the “1940 Act”), which addresses the valuation practices of registered investment companies and business development companies (each, a “fund”). The Fair Value Rule establishes a specific framework and a standard of baseline practices across funds to determine fair value in good faith for purposes of the 1940 Act. This article provides an overview of the Fair Value Rule, followed by a more detailed summary of the key provisions, including relevant guidance provided by the SEC in the release adopting the Fair Value Rule (the “Adopting Release”). For additional details on the SEC’s initial proposal, see Goodwin’s previous client alert from April 29, 2020, available at: [www.goodwinlaw.com/publications/2020/04/04\\_29-sec-proposes-new-rule-to-change](http://www.goodwinlaw.com/publications/2020/04/04_29-sec-proposes-new-rule-to-change)

The SEC last addressed valuation under the 1940 Act in a comprehensive manner roughly 50 years ago, in a pair of SEC releases in 1969 and 1970, Accounting Series Release 113 (“ASR 113”) and Accounting Series Release 118 (“ASR 118”)[1] Since then, market and fund investment practices have evolved significantly. As a result, fair valuation practices have also evolved in connection with funds investing in a greater variety of securities and other instruments, which present different and more significant valuation challenges that require greater resources and in-depth expertise to fair value determinations. There has also been an increase in both the volume and type of data used in fair value determinations and an increased use of third-party pricing services to provide pricing information, particularly for thinly traded or more complex assets.

In addition, the following regulatory developments since ASR 113 and ASR 118, taken together, have fundamentally altered how boards, funds, investment advisers and other fund service providers perform various functions relating to fair value determinations:

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- the enactment of the Sarbanes Oxley Act of 2002 and the adoption of rules mandated by that Act (which established the Public Company Accounting Oversight Board (the “PCAOB”) and criteria necessary for the work product of an accounting standard-setting body to be recognized as “generally accepted” for purposes of the federal securities laws);
- the SEC’s adoption in 2003 of compliance rules under the 1940 Act (Rule 38a-1) and the Investment Advisers Act of 1940 (Rule 206(4)-7) (which require a fund to adopt compliance policies and procedures with respect to fair value); and
- the codification by the Financial Accounting Standards Board of Accounting Standard Codification Topic 820; Fair Value Measurement (“ASC Topic 820”) [which defines the term “fair value”<sup>[2]</sup> for purposes of the accounting standards and establishes a framework for the recognition, measurement, and disclosure of fair value under U.S. generally accepted accounting principles (“U.S. GAAP”)].

Since ASR 113 and ASR 118, there has also been subsequent guidance issued by the SEC and its staff, at different times and in different forms, on the role of the board regarding fair value under the 1940 Act. This guidance is set forth in, among other documents, a pair of letters from the SEC staff to the Investment Company Institute in 1999 and 2001, the SEC’s release adopting Rule 38a-1 in 2003, an SEC order finalizing a settlement with former fund directors over claims related to fair value determinations in 2013, and the SEC’s release adopting amendments to the rules governing money market funds in 2014 (the “2014 MMF Release”). This combination of guidance in various releases, letters, statements and other communications over time has created an inefficient regulatory framework where the board’s role with respect to fair value is not always clear to funds and their boards.

The Fair Value Rule establishes a revised framework for the fair value determination process that recognizes and reflects the considerable changes that have taken place since ASR 113 and ASR 118. Additionally, the comprehensiveness of the new rule creates a more consistent and efficient regulatory framework that is designed to reduce confusion and provide additional clarity on how boards can effectively fulfill their fair valuation determination obligations in light of these changes. Significantly, and in recognition of investment advisers assisting funds with fair value determinations, the new rule expressly permits a board to designate the performance of fair value determinations to the fund’s primary investment adviser (but not a sub-adviser), subject to certain additional requirements designed to facilitate the board’s ability effectively to oversee the adviser’s fair value determinations.

The Fair Value Rule became effective March 8, 2021 and will allow for an 18-month transition period beginning from that date, meaning that the compliance date is scheduled to be September 8, 2022. Upon the compliance date, the list of existing guidance from the SEC and its staff, as specified in the Adopting Release, addressing a board’s determination of fair valuation and other matters covered by the Fair Value Rule, including ASR 113 and ASR 118 (collectively, “Existing Fair Value Guidance”), will automatically be rescinded or withdrawn.

A fund is permitted to elect to voluntarily comply with the Fair Value Rule prior to the compliance date. However, to promote regulatory consistency, a fund that chooses early voluntary compliance may only rely on the Fair Value Rule, and not also the Existing Fair Value Guidance, for purposes of determining fair valuations under the 1940 Act. Accordingly, funds should consider the implications of early voluntary compliance with the Fair Value Rule.

Following the adoption of the Fair Value Rule, the SEC’s Division of Investment Management issued guidance in response to frequently asked questions (“FAQs”) related to the Fair Value Rule, which address, among other things, the impact of early voluntary compliance

on cross trades of fixed-income securities under Rule 17a-7. According to the FAQs, if a fund chooses to comply with the Fair Value Rule before the compliance date, the SEC staff would not object if the fund does not apply the Fair Value Rule's definition of "readily available" market quotations to its cross-trading practices under Rule 17a-7 until the compliance date.

The FAQs also provide guidance on the timing for possible audit scope changes. In particular, the staff would not object if an auditor, for fiscal periods ending on or after March 31, 2021, stops looking to the guidance in ASR 118 and instead determines the appropriate audit valuation approach by following only PCAOB standards. As noted above, the SEC is rescinding ASR 118, which is the basis for the current requirement that auditors test valuation for 100% of portfolio positions. In the Adopting Release, the SEC noted that PCAOB standards would permit sampling and other techniques to verify the value of a fund's investment, but a fund board or valuation designee could request that its auditor continue the current practice of 100% verification if the board or valuation designee determines that the current practice is preferable.

## 1. Overview of fair value rule

Pursuant to Section 2(a)(41) of the 1940 Act, the term "value" has two prongs:

1. the value of securities for which "market quotations are readily available" is their "market value"; and
2. the value of "other securities and assets" is their "fair value" as determined "in good faith by the board of directors."

As interpreted by the SEC and its staff, the framework combines substantive directives of permissible and impermissible methods for determining "value" with procedural directives regarding the role of the board in determining value, particularly "fair value."

The Fair Value Rule establishes a set of required functions that must be performed in order to determine in good faith the fair value of a fund's investments for purposes of applying Section 2(a)(41) (the "Required Functions"). The Required Functions are:

- Periodically assessing and managing material valuation risks;
- Establishing and applying fair value methodologies;
- Testing the established fair value methodologies; and
- Overseeing and evaluating any pricing services.

A fund's board of directors (defined in the Valuation Rule as either the entire board or a designated committee of such board composed of a majority of the independent directors) may choose to determine fair value in good faith for any or all fund investments, in which case the board must carry out all of the Required Functions. Alternatively, a fund's board may "designate" the performance of fair value determinations relating to any or all fund investments to the fund's primary investment adviser (but not a sub-adviser) or, if the fund is internally managed, to an officer or officers of the fund (the "valuation designee"). The valuation designee would then carry out all of the Required Functions, subject to the following additional conditions designed to facilitate the board's oversight of the valuation designee's fair valuation determinations:

1. *Quarterly Board Reports.* At least quarterly, the valuation designee must provide to the board a written report summarizing or describing material fair value matters that occurred in the prior quarter, as well as any additional reports requested by the board related to the fair value of the fund's investments or the valuation designee's fair value process;

2. *Annual Board Reports.* Annually, the valuation designee must provide to the board a written assessment of the adequacy and effectiveness of the valuation designee's fair value process;
3. *Prompt Board Notifications.* Between board meetings, the valuation designee must provide to the board a written notification of the occurrence of matters that materially affect the fair value of the designated investments no later than five business days after the valuation designee becomes aware of the material matter; and
4. *Reasonable Segregation from Portfolio Management.* The valuation designee must:
  - specify the titles of the persons responsible for determining the fair value of the designated investments and
  - reasonably segregate fair value determinations from the portfolio management of the fund.

The board's role in the valuation of a portfolio investment for purposes of fair value depends on whether or not market quotations are "readily available" for such an investment. The Fair Value Rule establishes a definition of the term "readily available," which previously was undefined. Under the new definition, 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 "readily available" definition is consistent with the definition of a "level 1" input in the fair value hierarchy outlined in U.S. GAAP. The SEC explicitly stated that the new definition will apply in all contexts under the 1940 Act and the rules thereunder, including Rule 17a-7 under the 1940 Act. Accordingly, because most fixed-income securities are valued using "level 2" inputs under the U.S. GAAP hierarchy, the SEC acknowledged that certain cross trades currently permitted under Rule 17a-7 will no longer be permitted under this new definition.

In addition, the SEC adopted a separate recordkeeping rule, new Rule 31a-4 (the "Recordkeeping Rule"), requiring the fund or the valuation designee, as applicable, to maintain "appropriate" documentation to support fair value determinations.

## 2. Definition of "readily available" market quotations and implications for rule 17a-7 cross trades

Until the adoption of the Fair Value Rule, the term "readily available" was not defined in the 1940 Act or the rules thereunder. The Fair Value Rule establishes the following definition to be used in determining whether a market quotation is "readily available" for purposes of Section 2(a)(41) of the 1940 Act:

"[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."

This definition is consistent with the definition of a "level 1" input in the fair value hierarchy outlined in U.S. GAAP. Thus, under this definition, a security will be considered to have readily available market quotations if its value is determined *solely* by reference to these level 1 inputs.<sup>[3]</sup> In all other circumstances, including where securities are valued using "level 2" inputs in the U.S. GAAP hierarchy, fair value would have to be used.<sup>[4]</sup>

The SEC stated that "evaluated prices," "indications of interest," and "accommodation quotes" involve the use of level 2 inputs and, therefore, will not qualify as readily available market quotations for purposes of the new definition. Most fixed-income securities are valued on the basis of such information (i.e., level 2 inputs) and will have to be fair valued.

Additionally, a quotation will not be readily available under the new definition if it is not reliable. A quote will be considered unreliable (and therefore will not be readily available) in the same circumstances where it requires adjustment under U.S. GAAP or where U.S. GAAP requires consideration of additional inputs in determining the value of the security. For example, a fund could use a previous closing price for a security that principally trades on a closed foreign market to calculate the value of that security, except when an event has occurred since the time that the value of that security was established that is likely to have resulted in a change in such value. Under those facts, the previous closing price would be considered unreliable and therefore will not be readily available under the new definition.

In the Adopting Release, the SEC stated that the new definition of “readily available” will apply in all contexts under the 1940 Act and the rules thereunder, including Rule 17a-7. Rule 17a-7 permits cross-trades between affiliated funds (e.g., funds with the same primary investment adviser) provided certain conditions are met, including that the trade involves a security for which market quotations are readily available. Accordingly, if market quotes are not readily available under the new definition, the relevant security may not be cross-traded in reliance on Rule 17a-7.

Because most fixed-income securities are valued on the basis of level 2 inputs, absent additional action by the SEC or the staff, these securities will not be eligible for cross trades under Rule 17a-7 under the new definition. In that regard, the SEC recognized that “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 thus would not be available for such trades.” The SEC also acknowledged that many cross trades today are conducted in reliance on no-action letters issued by the SEC staff in the context of certain transactions under Rule 17a-7. The SEC noted that its staff is reviewing these letters to determine whether the letters (or a portion thereof) should be withdrawn and, separately, that consideration of potential revisions to Rule 17a-7 is on the SEC’s rulemaking agenda. The SEC has begun informal discussion with the industry on these matters and has specifically invited comments as it undertakes consideration of any impact on Rule 17a-7.

On March 11, 2021, the SEC’s Division of Investment Management issued a statement on cross trading, reiterating the SEC’s statements from the Adopting Release, as described above, and requesting “feedback [...] in evaluating what, if any, recommendations the Staff might make to the Commission in this area.” On April 9, 2021, the Investment Company Institute submitted its response to the SEC staff’s statement, which includes policy recommendations for a modernized cross trading regulatory framework. A key element of these recommendations is that, rather than require that a security have a readily available market quotation to be eligible for cross trading, the SEC should permit funds to cross trade securities that meet the definition of having level 1 or level 2 inputs under the U.S. GAAP hierarchy.

Certain no-action letters currently relied upon to conduct transactions under Rule 17a-7 do not directly pertain to the condition that the securities being crossed must have readily available market quotations. For example, in the *Benham* no-action letter (January 27, 1995), the SEC staff stated that it would not recommend enforcement action if affiliated funds effected cross-trades involving variable rate demand notes, for which it is impracticable to obtain two independent bids, and valued the notes at par plus accrued interest in order to meet the Rule 17a-7 condition that securities be valued at their “current market price.” These and other similar no-action letters may not be withdrawn because they are not directly contingent upon the definition of readily available market quotations, but funds relying on these letters should nonetheless consider whether any action by the SEC or the staff regarding Rule 17a-7 would have potential implications on the availability of these letters.

### 3. Required valuation functions

The Required Functions that must be performed by the board or valuation designee, as applicable, under the Fair Value Rule generally reflect the SEC’s understanding of current

practices used by funds to fair value their investments. As a result, although the codification of the Required Functions will formalize these current practices, it likely will not fundamentally change the way in which most funds currently fair value their investments. The SEC adopted the Required Functions substantially as proposed, but the SEC did provide some additional flexibility.

### ***3.1 Periodically assess and manage material valuation risks***

The Fair Value Rule requires “[p]eriodically assessing any material risks associated with the determination of the fair value of fund investments (‘valuation risks’), including material conflicts of interest, and managing those identified valuation risks.” The Fair Rule does not identify specific valuation risks to be addressed under this requirement. The Adopting Release, however, provides a non-exhaustive list of examples of sources or types of valuation risks, including:

- the types of investments held or intended to be held by the fund;
- extent to which each fair value methodology uses unobservable inputs;
- reliance on service providers that have more limited expertise in relevant asset classes and the use of fair value methodologies that rely on inputs from third-party service providers; and
- the risk that methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.

The Fair Value Rule does not establish any minimum frequency for re-assessing valuation risks. Different frequencies, such as annually or quarterly, may be appropriate depending on the particular fund and its valuation risks. The Fair Value Rule also does not list any specific factors that must be considered in conducting this periodic assessment. However, the SEC stated its belief that the periodic re-assessment “generally should take into account changes in fund investments, significant changes in investment strategy or policies, market events, and other relevant factors.”

### ***3.2 Establish and apply fair value methodologies***

The Fair Value Rule requires establishing and applying fair value methodologies. To satisfy this requirement, the board or valuation designee, as applicable, taking into account a fund’s valuation risks, must take the following steps:

**Select and Apply Appropriate Fair Value Methodologies.** The board or valuation designee, as applicable, must select and apply “in a consistent manner an appropriate methodology or methodologies for determining (and calculating) the fair value of fund investments.” In order to be “appropriate,” the selected methodology must be consistent with those used to prepare the fund’s financial statements and, therefore, must be consistent with the principles of the valuation approaches laid out in ASC Topic 820. These principles provide that an investment is valued based on the exit price at the measurement date from the perspective of a market participant under current market conditions. The SEC also clarified that selecting and applying methodologies “in a consistent manner” does not restrict a change to a different methodology under circumstances in which the change “would result in a measurement that is equally or more representative of fair value.”

**Periodically Review the Methodologies and Make Any Necessary Changes.** The board or valuation designee, as applicable, must periodically review “the appropriateness and accuracy of the methodologies selected and mak[e] any necessary changes or adjustments.” Adjustments could be necessitated based on, for example, the results of back-testing or calibration or a change in circumstances specific to an investment.

Monitor for Circumstances that May Necessitate the Use of Fair Value. The board or valuation designee, as applicable, must monitor “for circumstances that may necessitate the use of fair value.” For example, if a fund invests in securities that trade in foreign markets, the board or valuation designee, as applicable, generally should identify and monitor for the kinds of significant events that, if they occurred after the market closes in the relevant jurisdiction but before the fund prices its shares, would materially affect the value of the security and therefore may suggest that market quotations are not reliable.

### ***3.3 Test fair value methodologies***

The Fair Value Rule requires the board or valuation designee, as applicable, to “[test] the appropriateness and accuracy of the methodologies used to calculate fair value.” This includes the identification of:

- the testing methods to be used” and
- the “minimum frequency with which such testing methods are used.

The SEC highlighted calibration and back-testing as examples of particularly useful testing methods that may assist in identifying poor service providers or potential conflicts, but there is no requirement for particular testing methods or a specific minimum testing frequency. The SEC reiterated that these matters depend on the circumstances of each fund and thus should be determined by the board or valuation designee, as applicable. Notably, there is no *de minimis* exception to the testing requirement under the Fair Value Rule, so testing must be conducted even for funds with a limited amount of fair value investments.

### ***3.4 Evaluate pricing services***

The Fair Value Rule requires the oversight and evaluation of any pricing services used. This requires the board or valuation designee, as applicable, to establish the process for:

- approving and monitoring each pricing service provider and
- initiating price challenges as appropriate.

The SEC replaced its proposed requirement for funds to establish *criteria* for initiating price challenges with the requirement that funds establish a *process* for initiating price challenges, citing commenters’ concerns that there can be a range of circumstances under which a price challenge may be warranted, some of which cannot be distilled into specific criteria in advance.

The Adopting Release also contains the SEC’s views on how oversight and selection of pricing services may be effectively conducted, which is largely consistent with its previous guidance from the 2014 MMF Release but reflects the “designation” process established in the Fair Value Rule. For example, the SEC lists certain factors that a fund’s board or valuation designee, as applicable, generally should take into consideration before deciding to use a pricing service. These SEC views, as set forth in the Adopting Release, supersede the guidance in the 2014 MMF Release regarding the use of pricing services. However, as relevant to money market funds that use the amortized cost valuation method, the SEC did not modify or supplement the SEC’s prior guidance regarding the use of the amortized cost method because, with respect to amortized cost valuation, the SEC “continues to believe that [its] prior guidance, as discussed in the 2014 [MMF] Release, remains relevant, adequate, and appropriate.”

### ***3.5 Fair value policies and procedures***

As proposed, the Fair Value Rule would have separately required a fund to adopt written policies and procedures reasonably designed to achieve compliance with the requirements

of the Fair Value Rule. The SEC removed this *separate* policies and procedures requirement from the final rule, noting that “federal securities laws” for purposes of Rule 38a-1 under the 1940 Act will include the Fair Value Rule and the Recordkeeping Rule. Accordingly, Rule 38a-1 will require the adoption and implementation of written policies reasonably designed to prevent violations of the Fair Value Rule and the Recordkeeping Rule. These fair value policies and procedures must be approved by the fund’s board pursuant to Rule 38a-1 and may not be considered material amendments to existing fair value policies and procedures that would only need to be reported to the board. Where a board designates the fund’s investment adviser as valuation designee to perform fair value determinations, the investment adviser will adopt and implement the fair value policies and procedures under Rule 38a-1 (without the need for the fund to adopt duplicative policies separately), and these adviser policies and procedures must still be approved by the board.

#### 4. Valuation designee

As indicated above, as an alternative to choosing to perform fair value determinations and directly carrying out the Required Functions, a board instead may “choose to designate the valuation designee to perform the fair value determination relating to any or all fund investments.” Under this alternative, the valuation designee would be required to carry out all of the Required Functions, subject to the board’s oversight.

For externally managed funds, the Fair Value Rule permits a board to designate only the fund’s primary investment adviser, *but not a sub-adviser*, as the valuation designee. For internally managed funds that have no investment adviser, a board may designate only an officer or officers of the fund as the valuation designee. The SEC declined requests to expand the list of permissible entities that could serve as valuation designees, such as affiliates of the adviser, fund administrators, pricing services, and committees composed of a blend of personnel, on the basis that “it is critical for the entity actually performing the fair value determinations to owe a fiduciary duty to the fund and be subject to direct board oversight where possible.”

In a change from the rule proposal, the Fair Value Rule does not permit a board to designate one or more fund sub-advisers as the valuation designee, although boards or their valuation designee can seek the assistance of sub-advisers as they see appropriate. The SEC noted that any benefits provided by the additional flexibility of designating fund sub-advisers would not be justified by the additional challenges it may create, including, in the view of the SEC, increased complexity and complicated reconciliation and oversight issues for boards, advisers and sub-advisers.

Notwithstanding the limitations described above, in fulfilling its duties under the Fair Value Rule, the valuation designee (and the board) may obtain assistance from others, including pricing services, fund administrators, sub-advisers, accountants, or counsel. That assistance can take different forms, and may include services such as performing back-testing as specified by the valuation designee and performing calculations required by the selected methodology. However, the SEC clarified that, in seeking the assistance of others, the valuation designee remains responsible for the performance of the fair value determinations and may not designate or assign that responsibility to any third party.

If the board designates the performance of fair value determinations, the Fair Value Rule requires the valuation designee to, among other things, specify the titles of the persons responsible for determining the fair value of the designated investments, which includes specifying the particular functions for which the persons identified are responsible. Additionally, the valuation designee would be required to reasonably segregate fair value determinations from the portfolio management of the fund. This requirement does not prohibit portfolio managers from participating in the fair value determination process (e.g., to provide inputs), but the fund’s portfolio manager(s) may not determine, or effectively



determine by exerting substantial influence on, the fair values ascribed to the designated investments. The SEC acknowledged that this requirement may create certain challenges for smaller advisers due to their limited numbers of personnel.

The use of the term “designate” in the Fair Value Rule is a change from the proposal that would have provided that the board may “assign” the performance of fair value determinations. After considering commenters’ concerns that the scope of an assignment was unclear, the SEC chose to use the term “designate” instead of “assign” in the Fair Value Rule, believing that this term “better describes the relationship between the board and valuation designee [...] that is, one where the valuation designee performs the fair value determinations for the fund on the board’s behalf subject to appropriate oversight by the fund’s board.” The SEC acknowledged some commenters’ belief that the term “assign” could suggest that the board has completely delegated the entire valuation function and related obligations to the adviser, and the SEC stated that “[w]e did not intend this result.”

In the case of a unit investment trust (“UIT”), because a UIT does not have a board of directors or adviser, a UIT’s trustee, or, in a change from the rule proposal, the UIT’s depositor, must perform fair value determinations under the Fair Value Rule and carry out the Required Functions.

## 5. Guidance on board oversight role

The Fair Value Rule specifically requires a board to oversee the valuation designee if the board has designated the performance of fair value determinations to the valuation designee. The Adopting Release contains a dedicated four-page section of specific guidance with respect to board oversight in this context. The guidance is not part of the Fair Value Rule itself, but is formal guidance from the SEC nonetheless.

In deciding that specific guidance would be appropriate, the SEC noted that determining fair value in good faith is one of the few statutory board responsibilities set forth in the 1940 Act, and that the guidance would support the SEC’s view that a board may still satisfy its statutory obligation even though it has designated another entity to perform the fair value determinations subject to appropriate oversight. However, the SEC declined requests to confirm that boards may provide oversight of the performance of fair value determinations consistent solely with the business judgment rule under state law. Instead, the SEC stated that it believes that providing specific guidance “should be more useful to directors than the more generalized principles of the business judgment rule.”

The specific guidance contained in the Adopting Release provides the SEC’s expectations on board oversight of the fair value determination process, and is substantially similar to the guidance provided in the rule proposing release. The SEC’s guidance includes the following:

“[A]ppropriate oversight cannot be a passive activity.”

“Boards should approach their oversight of the performance of fair value determinations by the valuation designee of the fund with a skeptical and objective view that takes account of the fund’s particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determination process, and the skill and resources devoted to it.”

“We expect that boards engaged in this process would 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 [...]. As the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, we expect that the board’s level of scrutiny would increase correspondingly.”

“[C]onsistent with their obligations under the Act and as fiduciaries, boards should seek to identify potential conflicts of interest, monitor such conflicts, and take reasonable steps to

manage such conflicts. In particular, the fund's adviser may have an incentive to value fund assets improperly in order to increase fees, improve or smooth reported returns, or comply with the fund's investment policies and restrictions. Other service providers [ . . . ] may have incentives [ . . . ] or may otherwise be subject to pressures to provide pricing estimates that are favorable to the valuation designee."

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

"[I]f the board becomes aware of material matters (whether the board identifies the matter itself or the fund's CCO, valuation designee, or another party identifies the issue), we believe that in fulfilling its oversight duty the board must inquire about such matters and take reasonable steps to see that they are addressed."

The Fair Value Rule does not require boards to ratify fair value determinations made by the valuation designee or to otherwise make any specific findings. The SEC stated that such ratifications or other findings are "not a necessary component of active oversight."

## 6. No safe harbor

Many commenters on the proposed rule recommended that the SEC recast the rule as a non-exclusive "safe harbor," which would have provided one means — but not the only approach — for satisfying the statutory standard. In support of this position, commenters noted that fair value in good faith is a flexible concept, and thus fair value determinations are not amenable to a single approach. The SEC declined to establish a safe harbor. In so doing, the SEC emphasized the importance of establishing "a minimum and consistent framework for fair value practices across funds." Further, the SEC noted that the Fair Value Rule does not establish a single approach to making fair value determinations. Instead, it establishes a "principles-based framework" for boards to use in creating their own specific process for making fair value determinations, which provides flexibility that the SEC views as sufficient for all fund boards to be able to comply with their statutory obligations.

Some commenters also raised concerns that violations of the technical elements of the Fair Value Rule (e.g., a failure to keep records for the prescribed period) could raise doubts about whether a valuation was made consistent with the requirements of the 1940 Act. In response to these concerns, the SEC tailored certain of the proposed reporting requirements (as discussed below) and moved the proposed recordkeeping requirements of the Fair Value Rule into the separate Recordkeeping Rule, which ensures that a recordkeeping failure by the adviser, for example, does not lead to a determination that the board did not value investments in good faith. The SEC also clarified that a "violation of the final rule does not necessarily mean that the actual value ascribed to particular fund investments were in fact inappropriate, or, for example, that the fund has violated rule 22c-1."

## 7. Board reporting

The Fair Value Rule imposes minimum board reporting obligations on the valuation designee in order to facilitate appropriate oversight by the board when a board has designated the performance of fair valuation to a valuation designee. The valuation designee is required to report to the board regarding its performance of the fair valuation determinations, including certain periodic reports (quarterly and annual reports) and

prompt notification on matters that materially affect the fair value of the designated investments. In response to comments, the SEC provided more flexibility in board reporting than proposed.

### ***7.1 Quarterly reporting***

At least quarterly, the valuation designee is required to provide, in writing, a summary or description of material fair value matters that occurred in the prior quarter, including (i) any material changes in the assessment and management of valuation risks, including material changes in conflicts of interest of the valuation designee (and any other relevant service provider), (ii) any material changes to, or material deviations from, the fair value methodologies employed and (iii) any material changes to the valuation designee's process for selecting and overseeing pricing services, as well as any material events related to the valuation designee's oversight of pricing services.

In addition, the valuation designee is required to provide any reports or materials requested by the board related to the fair value of the fund's investments or the valuation designee's process for fair valuing fund investments. By expressly recognizing boards' authority to require any additional reports they want on a quarterly basis, the Fair Value Rule seeks to empower boards to tailor periodic reporting to suit the needs of a fund. This flexibility to request additional information replaced the reporting regime in the proposed rule that would have required quarterly reporting on a variety of valuation matters that commenters argued would be better suited in an annual report, would be too costly for advisers to produce on a quarterly basis, and/or would not change frequently enough to justify quarterly reporting.

In the context of the quarterly reporting requirements adopted in the Fair Value Rule, the SEC indicated that "material" matters would generally be those matters about which the board would reasonably need to know in order to exercise appropriate oversight of the valuation designee's fair value determination process (which is similar to the "material compliance matter" standard in Rule 38a-1).

### ***7.2 Annual reports***

At least annually, the valuation designee is required to provide, in writing, an assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of the designated portfolio of investments, including:

- a summary of the results of the testing of fair value methodologies employed; and
- an assessment of the adequacy of resources allocated to the process for determining the fair value of a fund's investments, including any material changes to the roles or functions of the persons responsible for determining fair value.

The proposed rule would have required this assessment to be provided to the board on a quarterly basis.

### ***7.3 Prompt Rreporting***

The valuation designee is required to notify the board, in writing, of matters that materially affect the fair value of the designated investments within five business days after the valuation designee becomes aware of the material matter (or within a shorter period determined by the board). "Material" matters that would need to be reported include, for example, a "significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process" (which borrows from accounting and financial reporting concepts related to internal controls), as well as "material errors in the calculation of net asset value." The valuation designee is also required to provide follow-up reporting as the board may determine appropriate. This follow-up requirement replaced the

provision in the proposed rule that would have required prompt reporting on matters that “could have” materially affected the fair value of the designated investments, which commenters questioned as overly broad with a potential for excess reporting.

In an additional change from the proposed rule, the SEC extended the specified reporting period under the Fair Value Rule from three business days to five business days to give valuation designees sufficient time to coordinate and prepare communications for the board regarding a material matter that meets the standard for prompt notification. Accordingly, in cases where the materiality of a matter is immediately apparent, the SEC expects that the valuation designee would report the material matter to the board within the five-business day period.

Where the materiality of a matter is in question, the SEC recognized that the valuation designee may need an additional period of time to determine and verify whether the matter materially affects the fair value of a fund’s investments. In those instances, the valuation designee would have up to 20 business days after becoming aware of the relevant valuation matter to determine the materiality of the matter in question. If the valuation designee is unable to determine the matter’s materiality within that 20-business day period, the SEC expects that the valuation designee would notify the board of its on-going evaluation of the matter within the following five business days. The SEC stated, however, that the valuation designee should not take the full 20 business days as a matter of course, and instead should act promptly in seeking to determine the materiality of a matter.

## 8. Recordkeeping

The separate Recordkeeping Rule requires that funds or their advisers maintain “appropriate” documentation to support fair value determinations. The SEC stated that it believes such records should include documentation that would be sufficient for a third party, such as the SEC staff, to verify, but not fully recreate, the fair value determinations. In addition, the Recordkeeping Rule provides that, in cases where the board has designated the performance of fair value determinations to a valuation designee, funds or their advisers must maintain the reports and other information provided to the board pursuant to the periodic reporting and prompt notification requirements, as well as a specified list of the investments or investment types for which the valuation designee has been designated.

These records generally will be required to be maintained for six years, the first two in an easily accessible place. Funds will be required to maintain these records, unless a board has designated the performance of fair value determinations to an investment adviser, in which case the investment adviser will maintain these records.

## Notes

1. In general, ASR 113 addressed a number of federal securities law and accounting topics related to the purchase of restricted securities by funds, including how to determine fair value for such securities. A year later, ASR 118 expressed the SEC’s views on certain valuation matters, including accounting and auditing, as well as the role of the board in the determination of fair value. The SEC acknowledged in ASR 113 and ASR 118 that the board need not itself perform each of the specific tasks required to calculate fair value in order to satisfy its obligations under the 1940 Act. However, under ASR 113 and ASR 118, the board chooses the methods used to arrive at fair value, and continuously reviews the appropriateness of such methods. In addition, the SEC stated that boards should consider all appropriate factors relevant to the fair value of securities for which market quotations are not readily available. The SEC also stated that whenever technical assistance is requested from individuals who are not directors, the findings of such individuals must be carefully reviewed by the directors in order to satisfy themselves that the result valuations are fair.
2. In contrast to the 1940 Act, ASC Topic 820 uses the term “fair value” to refer generally to the value of an asset or liability, regardless of whether the value is based on readily available market quotations or on other inputs.

3. Securities valued using level 1 inputs include those that are quoted on an active market for identical assets that the reporting entity can access at the measurement date (e.g., listed securities)
4. Securities valued using level 2 inputs include those that are not traded on an active market and/or are valued using inputs other than quoted prices for the specific security (e.g., credit spreads).

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