



VRC



VALUE INSIGHTS

**NAVIGATING
SEC RULE 2A-5:**

**A VRC
RESOURCE
GUIDE**

INSIDE:

Frequently Asked
Questions

5 Key Observations

Rule Evolution

Board Requirements

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Considerations

FREQUENTLY ASKED QUESTIONS ABOUT RULE 2A-5

WHAT IS RULE 2A-5?

Rule 2a-5 is the newly adopted rule under the SEC's Investment Company Act of 1940, which provides requirements for determining fair value in good faith by boards of directors concerning the fair value of the investments of a registered investment company or a business development company.

WHY WAS RULE 2A-5 RELEASED BY THE SEC?

The SEC's previous guidance was established over 50 years ago (ASR 113 and ASR 118). The SEC recognized significant developments have since occurred in the markets and fund investment practices, including the release of the FASB's ASC 820 and the continued sophistication and related growing complexity of valuations of securities held by RICs and BDCs.

WHAT ARE RULE 2A-5'S MAIN PROVISIONS?

The determination of fair value by boards will generally involve:

- Assessing and managing material risks associated with fair value determinations
- Selecting, applying, and testing fair value methodologies
- Overseeing and evaluating any pricing services used

Under the Act, rule 2a-5 also defines when market quotations are readily available. Concurrently, the SEC is also adopting rule 31a-4, which provides the recordkeeping requirements associated with fair value determinations.

WHO IS RESPONSIBLE FOR THE PERFORMANCE OF FAIR VALUE DETERMINATIONS AND ENSURING COMPLIANCE WITH RULE 2A-5?

A fund's board, either in full or a designated committee thereof, is required to determine in good faith the fair value of its investments. However, to allow the board to focus on overall fund oversight and governance—and since board members “are unlikely to have the necessary experience, knowledge, skills or resources to carry out the day-to-day” fair value determinations—the rule permits the board to designate certain parties to perform the fair value determinations, subject to board oversight and certain reporting and other requirements.

WHO CAN BE DESIGNATED, AND WHAT ARE THE GENERAL DESIGNEE REQUIREMENTS?

The board may designate fair value determination duties only to an adviser or an officer for internally managed funds. These parties owe a fiduciary duty to the fund. However, they may seek assistance from various other parties that provide essential services for fair value determinations.



WHAT ARE THE DESIGNEE'S REPORTING AND RECORDKEEPING REQUIREMENTS?

Rule 2a-5 requires two general types of reports:

1. Periodic reports:
 - Quarterly reports must include any specific reports or materials requested by the board and a summary of material matters occurring during the quarter.
 - Annual reports should assess the overall adequacy and effectiveness of the valuation designee's process.
2. Prompt reporting requires the designee to provide written notification of a material matter within a board-determined period, which is not to exceed 5 business days after the designee becomes aware of the matter and has determined, within 20 business days, that it is material.

Rule 31a-4 requires the fund to keep appropriate documentation to support fair value determinations for at least 6 years, maintaining the first 2 years in an easily accessible place. If designated, the fund must also keep copies of the reports provided to the board and a list of designated investments or investment types for generally the same period.

WHEN WAS RULE 2A-5 RELEASED, AND WHEN MUST FUNDS COMPLY WITH THE RULE?

Rule 2a-5 was released on December 3, 2020, and will become effective on March 8, 2021. Funds have 18 months from the effective date to comply (September 8, 2022).

HOW DOES THE SEC DEFINE MARKET QUOTES AS "READILY AVAILABLE," AND WHY IS THAT SIGNIFICANT?

Under the Act, if a market quote is "readily available," it must be used to value the security. If a market quote is not readily available, then the investment must be fair valued under all other circumstances. Quotes are considered readily available only when it is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that it will not be readily available if it is unreliable.

The SEC defines "readily available" as consistent with a Level 1 input in U.S. GAAP. Level 2 inputs, evaluated prices, indications of interest, and accommodation quotes are not considered readily available. A quote would not be reliable "where it would require adjustment under U.S. GAAP, or where U.S. GAAP would require consideration of additional inputs in determining" its value.

WHERE CAN I FIND THE SEC'S PRESS RELEASE AND A COPY OF THE FINAL RULE?

You can visit SEC.gov here:

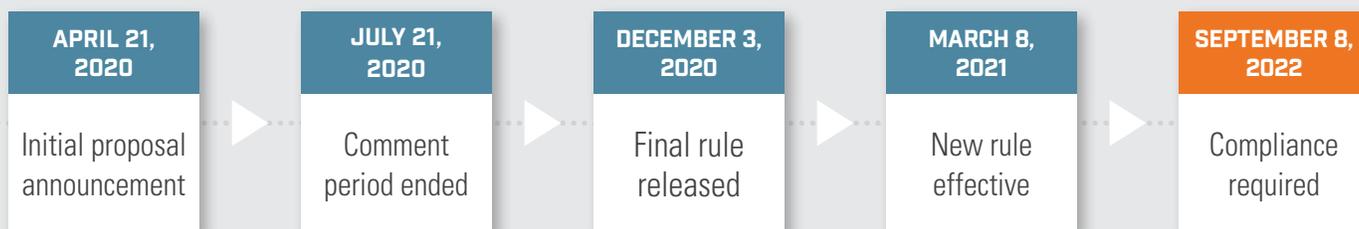
<https://www.sec.gov/news/press-release/2020-302>

WHO CAN I CONTACT AT THE SEC FOR MORE INFORMATION ON ACCOUNTING OR AUDITING MATTERS?

Contact the SEC's Chief Accounting Office,
Division of Investment Management:

 (202) 551-6918 |  IM-CAO@sec.gov

TIMELINE OF SEC RULE 2A-5



5 KEY OBSERVATIONS

THE PURPOSE OF RULE 2A-5

Rule 2a-5 applies to all registered investment companies and business development companies regardless of their sub-classification (open- or closed-end) or strategy (equity, fixed income, or index). The rule is intended to establish a minimum and consistent framework across all funds informed by current industry practice while providing flexibility to exercise judgment in the valuation process. Purposely written as more prescriptive than principles-based, the rule is intended to be applied more consistently among funds.

The Benefits of Proper Oversight

- Helps promote the mitigation of conflicts of interest and assists in managing investments and the fund for the benefit of shareholders.
- Resulting values are “more likely to reflect a price that could be obtained in arm’s length transactions with less bias.”
- Contributes to better measurement of the risk and return profile of investments and the fund and helps manage the fund under its investment objectives.
- Improves the accuracy of fee calculations and disclosures.
- Promotes fund share transactions at fair prices and helps avoid dilution of shareholder interests.
- Improves investors’ decisions as valuations are perceived to be reliable.

FAIR VALUE AS DETERMINED IN GOOD FAITH

Section II A within rule 2a-5 applies to the board or the appointed designee. Here we review five focus areas worth noting and provide general yet critical observations regarding designation requirements and guidelines.

FUNDS SHOULD GENERALLY CONSIDER CHANGES IN FUND INVESTMENTS, INVESTMENT STRATEGY, AND MARKET EVENTS.

1. Periodically Assess and Manage Valuation Risks

A frequency has not been mandated when re-assessment is necessary but should generally consider changes in fund investments, significant changes in investment strategy, market events, and other relevant factors. Section IIA provides a “non-exhaustive” list of examples of risks but stresses that boards have flexibility in determining the risks they deem as applicable and whether some may outweigh others.

Risk Examples

Types of investments held or intended to be held

Potential market shocks that may affect the designee’s ability to operate

Extent of use of unobservable inputs, particularly if from a designee

Proportion of fund assets valued at fair value and contribution to returns

Reliance of providers with limited experience or use of methodologies that rely on those providers and the extent of such outsource (i.e., fourth-party risk)

2. Establish and Apply Fair Value Methodologies

Funds must select and consistently apply an appropriate methodology or methodologies, including specifying key inputs specific to each asset class or portfolio holding. In the final rule, the SEC clarified that a “consistent application” does not preclude the fund from changing methodologies if warranted by the facts and circumstances. Such a change merely needs adequate documentation.

Further, the SEC asserts that the methods used must be consistent with the principles of ASC 820. If one of the methods used is inconsistent, the SEC “presume(s) that use of such a methodology would be misleading or inaccurate.” Once again, asserting there is no single appropriate methodology, also based on facts and circumstances.

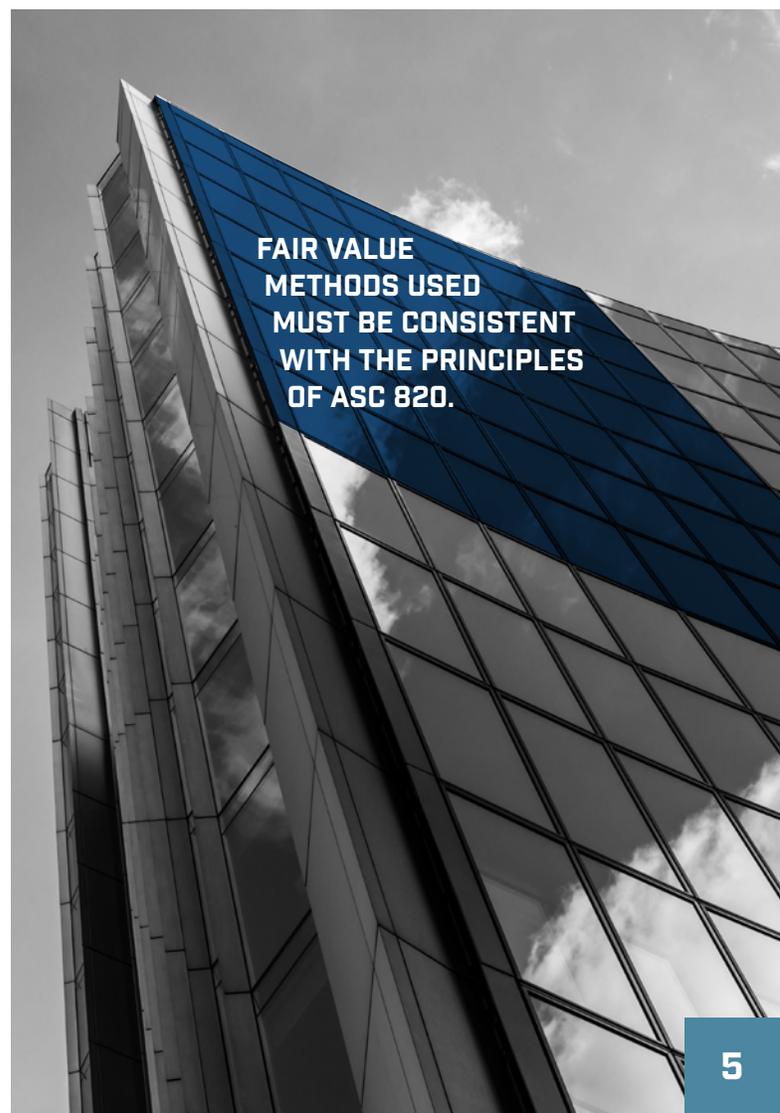
Debt securities cannot assume par or amortized cost based on a hold-to-maturity assumption if the fund cannot reasonably assume receiving approximately par or amortized cost at the measurement date under current conditions. The SEC also rejected the concept of an investment or a fund that “would not sell at this price” as adequate reasoning for not marking it down.

Potentially, as a result of back-testing or calibration, the final rule sets forth that funds must periodically review for the appropriateness and accuracy of the selected methodology. It is also important to understand that the SEC term for the use of fair value means that readily available quotes are not available. Therefore, fund boards of directors should monitor for situations where previously readily available quotes may now have become unavailable or unreliable. As such, boards will need to consider the circumstances that may cause the unreliability of market quotes.

3. Test Fair Value Methodologies for Appropriateness and Accuracy

Similar to the approaches the rule established that we’ve covered under item number two, boards are required to identify appropriate testing methods and a minimum frequency of testing the fair value methods selected. However, the SEC does not require particular methods to be used, nor do they require a specific minimum frequency for testing. Instead, the rule expects the “frequency and nature of testing would vary depending on the type and amount of investments held.”

Explicitly, the SEC cites calibration and back-testing as useful tools. Calibration refers to comparing the actual price paid to what would have been expected as a fair value price based on the selected methodology. The rule notes an exception, stating that these two tools are not required; boards have the flexibility to use other means if the fund deems it appropriate.



**FAIR VALUE
METHODS USED
MUST BE CONSISTENT
WITH THE PRINCIPLES
OF ASC 820.**

4. Pricing Services

Generally, the SEC describes pricing services 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 the fair value determination, and that this term is “generally understood by boards.” The SEC approached the final rule commentary related to pricing services to be consistent with the PCAOB’s definition.

PRICING SERVICES DEFINED: A THIRD-PARTY REGULARLY PROVIDING INFORMATION ON EVALUATED PRICES, MATRIX PRICES, PRICE OPINIONS, OR SIMILAR PRICING ESTIMATES THAT ASSIST IN THE DETERMINATION OF FAIR VALUE.

If pricing services are used primarily due to potential conflicts of interest, boards are required to establish a process for approving, monitoring, and evaluating each pricing service provider. They must also set a process for initiating price challenges, described as a “rigorous” analysis of the information provided. It is expressly noted in the final rule that if the fair value determination process is designated, the process remains subject to board oversight to eliminate designee potential conflicts.

Before deciding upon a pricing service, the SEC strongly recommends the board consider the following factors:

- Qualifications, experience, and history
- Valuation methods/techniques, inputs, and assumptions of different asset classes and how they are affected by market condition changes
- Information quality and the proximity of the information gathered to the measurement date
- Process of considering challenges and how they factor into the data
- Potential and actual conflicts of interest and the mitigation steps
- Testing processes used

While the rule does not require a review, it is generally expected to comply with rule 2a-5’s annual reporting review for the fair value process’s adequacy and effectiveness.

5. Fair Value Policies and Procedures

Rather than including a provision in the final rule that would have separately required a fund to adopt written policies and procedures reasonably designed to comply with 2a-5, the SEC acknowledged that existing compliance rule 38a-1 by its terms will require the adoption and implementation of written policies and procedures designed to prevent violations of 2a-5 and 31a-4.

Compliance rule 38a-1 requires a fund’s board to approve the fund’s policies and procedures and those of each adviser, based upon a finding by the board that they are reasonably designed to prevent violation of the Federal securities laws. Because 2a-5 and 31a-4 are new rules under the Act and given the intrinsic relationship of the rules to the board’s statutory functions relating to valuation, the policies and procedures must be approved by the board under 38a-1 and may not be considered material amendments to existing fair value policies and procedures.

COMPLIANCE RULE 38A-1 DOES NOT REQUIRE THE FUND TO ADOPT SEPARATE, DUPLICATIVE POLICIES AND PROCEDURES.

Under compliance rule 38a-1, policies and procedures are adopted and implemented by:

- The fund if the board is determining fair value
- The adviser, if one has been designated.
 - The board must approve the adviser’s policies and procedures under rule 38a-1. The fund does not need to adopt separate, duplicative policies and procedures. The SEC feels this approach allows for the requisite amount of policy and procedure detail while also providing flexibility.

WHAT EVOLVED FROM THE PROPOSAL STAGE TO THE FINAL RULE?

FAIR VALUE AS DETERMINED IN GOOD FAITH

(Page 4)

	PROPOSED	FINAL
	The fund's board of directors can assign the performance of fair value determinations, subject to the board's oversight.	The final rule's verbiage was adjusted to replace "assign" with "designate," which connotes performing duties on behalf, whereas "assign" could be mistaken to suggest delegation.
	The board may assign fair value determinations to a fund's primary adviser or one or more sub-advisers.	The board may "designate" fair value determinations only to the fund's adviser or an officer of the fund; the latter was added to the final rule to benefit internally managed funds.
ESTABLISH & APPLY FAIR VALUE METHODOLOGIES (Page 5)	Funds must select and consistently apply an appropriate methodology, including specifying key inputs specific to each asset class or portfolio holding.	Same as proposed, except that the selected methodologies may be changed if different methodologies are equally or more representative of fair value.
	An appropriate methodology must be predetermined for investments that the fund does not yet own.	The requirement was removed, citing undue burdens and noting that the rule already requires selecting an appropriate methodology.
	Funds must incorporate periodic reviews of the selected fair value methodologies for appropriateness and accuracy and adjust the methodologies if needed.	Same as proposed, except that changes to more appropriate methodologies, if determined, are permitted, and not just adjustments to previously selected methodologies.
	Specific criteria must be established for determining when market quotes are no longer reliable and, therefore, not readily available.	Fund boards must monitor for circumstances in which market quotes may no longer be reliable that may necessitate the use of fair value. Still, the establishment of specific criteria is no longer required.

	PROPOSED	FINAL
PRICING SERVICES (Page 6)	Boards must establish criteria for the circumstances under which price challenges would typically be initiated.	Boards must establish a process for the circumstances to initiate price challenges. "Criteria" as defined in the initial proposal, such as objective thresholds, were considered too rigid.
FAIR VALUE POLICIES AND PROCEDURES (Page 6)	Under rule 2a-5, the fund is separately required to adopt written policies and procedures reasonably designed to comply with 2a-5.	Policy and procedure compliance instead falls under existing compliance rule 38a-1 to prevent violations of rules 2a-5 and 31a-4.
BOARD REPORTING (Page 11)	Advisers are required to promptly report to the board in writing matters associated with the adviser's process that materially affect or could have materially affected the fair value of investments.	The final rule uses the term "material matters" rather than "could have materially affected" to better align with SEC rules and auditing standards. The final rule also generally requires annual reporting on the overall process with quarterly reports addressing material changes.
	Written reporting requirements of fair value process testing results and allocated resources' adequacy are prepared quarterly.	The final rule shifted this adequacy testing to an annual reporting requirement to add flexibility and avoid inundating the board with overly detailed and redundant information. Advisers are also required to prepare quarterly reports addressing board requests and material changes during the period.
	Quarterly reporting of test results, service provider changes, and price overrides.	To avoid providing an unnecessary level of detail, the final rule requires an annual summary of test results and eliminated the requirement to report service provider changes or price overrides.
	Advisers must promptly report in writing matters associated with the adviser's process that materially affect the fair value of investments.	The final rule clarifies that prompt reporting was not limited to issues related to the designee's process but of all matters that may require the board's immediate attention.
	In the case of a material event, the designee must promptly provide a written report to the board within three business days after becoming aware of the materiality matter. This materiality determination should be completed within three business days.	Prompt written board reporting for material issues must be delivered within five business days of becoming aware of the materiality. This materiality determination should be completed within 20 business days. Follow-up reporting is required as determined by the board.

	PROPOSED	FINAL
SPECIFICATION OF FUNCTIONS (Page 12)	<p>Portfolio management must be segregated from the process of making fair value determinations.</p>	<p>Final rule 2a-5 removes the phrase “process of” to clarify that the segregation requirement would not prevent portfolio managers from providing inputs used in the fair value determination process. Further, the final rule clarifies that the portfolio manager may not determine or ‘effectively determine’ the fair values by exerting substantial influence, for example those values solely based on inputs provided by that manager.</p>
RECORDKEEPING (Page 13)	<p>Records must be kept for five years after the end of the fiscal year in which the documents were provided to the board or the investments assigned to the adviser, the first two in an easily accessible place.</p>	<p>Records must be kept for a period beginning with the designation and ending at least 6 years after the end of the fiscal year the designation was terminated, and in an easily accessible place until 2 years after such determination. Also, recordkeeping requirements are governed under new rule 31a-4 primarily to ensure that failure to keep the required records would not lead to the board’s violation of 2a-5.</p>
	<p>Detailed records of the pricing service’s specific methods applied, assumptions, and inputs.</p>	<p>It is no longer required within the final rule. It is considered impractical and covered under the fund’s initial due diligence in selecting the pricing service and its ongoing oversight.</p>
	<p>Maintain copies of fair value policies and procedures.</p>	<p>This was eliminated from the final rule as it duplicates the recordkeeping requirements of the same adopted under existing compliance rule 38a-1.</p>
TRANSITION PERIOD (Page 14)	<p>Funds have a 12-month transition period to come into compliance with proposed rule 2a-5.</p>	<p>As funds may need to change certain practices, the SEC extended the compliance date to 18 months from the effective date. Compliance is required by September 8, 2022.</p>

REQUIREMENTS OF RULE 2A-5 FOR THE FUND'S BOARD OF DIRECTORS

DESIGNEE DUTIES DEFINED

Generally speaking, rule 2a-5 sets forth that the board can designate (rather than “assign”) the performance of fair value determinations subject to the board’s oversight. The designee requirements are to:

1. Make certain reports to the board,
2. Specify responsibilities, and
3. Reasonably segregate portfolio management from fair value determinations.

The designee adviser must be an “adviser of the fund” with “direct knowledge of the fund, a direct relationship to the board” and fiduciary duties. The SEC limited allowable designees as they believed that it was “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 whenever possible.” They note that conflicts exist by all parties, but fiduciary duty helps “eliminate, mitigate, or disclose” conflicts.

The rule does not permit designation to sub-advisers. However, boards or designees are allowed to seek assistance from “other parties that provide services that are essential for fair value determinations.”

The SEC also defines “board” as either the entire board or a designated committee thereof, composed of a majority of directors who are not “interested persons of the fund.” The SEC believes it is “important that boards be able to utilize specialized committees, particularly on matters as detailed and important as valuation.”

Designees may obtain assistance from various sources, including pricing services, fund administrators, accountants, or counsel. Assistance can take different forms, including back-testing or performing calculations required by the designee’s valuation method. Even when seeking outside assistance, the board or designee must fulfill their responsibilities and remain responsible for the fair value determination.

“IT IS IMPORTANT THAT BOARDS BE ABLE TO UTILIZE SPECIALIZED COMMITTEES, PARTICULARLY ON MATTERS AS DETAILED AND IMPORTANT AS VALUATION.”

BOARD OVERSIGHT DUTIES

It is critical to note that the SEC sets forth that board oversight is not a passive activity. Oversight must involve asking questions and seeking additional relevant information, mainly when “there are red flags or other indications of problems.” Boards should also “seek to identify potential conflicts of interest as part of their oversight duties.” To address or manage conflicts, a fund’s board must work with designees, who also must disclose conflicts.

BOARD REPORTING REQUIREMENTS

This section of rule 2a-5 addresses reporting requirements and represents them as a minimum board obligation. Fund boards may want to consider supplemental reporting as it may deem necessary based upon the facts and circumstances to fulfill its oversight duties. The SEC stresses that the specific content and representation (i.e., narratives, graphical models, statistical analyses, dashboards, exceptions-based reporting, etc.) of periodic and prompt reports are left to the prudent determination of the board and designees.

The SEC also defines the term “material matters” as those “about which the board would reasonably need to know to exercise appropriate oversight of the valuation designee’s fair value determination process.”

Quarterly Written Reporting Requirements

1. Any reports/materials requested by the board related to the fair value of designated investments or the designee’s fair value process.
2. Summary of material matters that occurred during the quarter, which must include:
 - a. Changes in the assessment of valuation risk, including changes in conflicts with a designee or other service provider
 - b. Changes to or deviations from fair value methodologies (i.e., changes to critical inputs or assumptions), including changes due to other methods that are “equally or more representative of fair value.” The SEC suggests funds summarize relevant market conditions or other circumstances, leading to an alternative method(s).
 - c. Changes to a designee’s process for selecting or overseeing pricing services or events related to this oversight (i.e., a pattern of price challenges or overrides over time.)

Annual Written Reporting Requirements

1. An assessment of the adequacy and effectiveness of the designee’s fair value determination process, at a minimum, must include:
 - a. A summary of fair value methodology testing results.
 - b. An assessment of process resource adequacy, including material changes to personnel roles or functions of those involved.

**BOARD OVERSIGHT IS NOT
A PASSIVE ACTIVITY.**

Prompt Board Reporting Requirements

1. The designee is generally required to notify the board of material matters within a board-determined time frame, allowing the board to respond promptly, as needed.
 - a. The report may be presented briefly (e.g., an email) with supplemental information to follow.
 - b. Notification can be provided either to the full board or a designated committee composed of a majority of directors tasked with carrying out appropriate oversight over valuations.
 - c. Material matters may be uncovered by the designee or through notification from an independent third party, such as an auditor.
2. Follow-on reports must be provided as reasonably requested by the board.
3. The designee has up to 5 business days from when they become aware of the materiality of a matter to submit their report to the board. They have 20 business days to determine the materiality of the matter. As a matter of course, the SEC urges that the designee should not take the full 20 days. If the materiality of the issue remains undetermined after 20 days, the advisor must inform the board of its ongoing evaluation within 5 business days.

Prompt Board Reporting Examples:

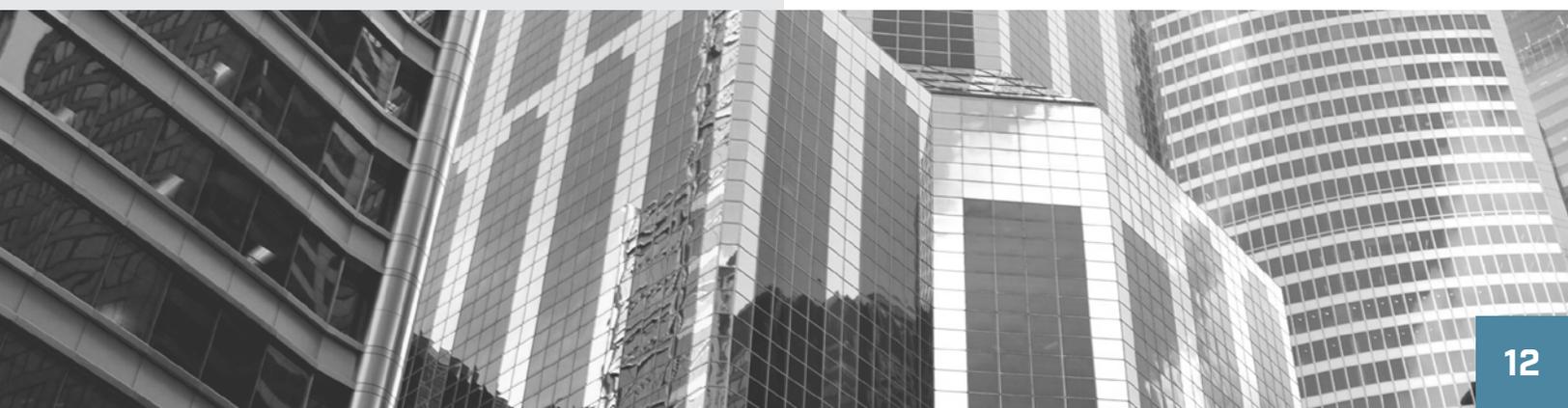
- Significant deficiency or material weakness in the design or effectiveness of the valuation determination process or a material error in calculating NAV.
- The SEC did not expressly define an NAV error materiality threshold but stated that the generally utilized industry standard of \$0.01/share or 0.5% is not unreasonable.

SPECIFICATION OF FUNCTIONS

Generally, the designee must specify the titles of persons responsible for the fair value determinations and the specific functions of those identified. This requirement is consistent with compliance rule 38a-1 to “enhance accountability and provide clear lines of responsibility.” Personnel with duties associated with price challenges, including the authority to override, must be identified, and the designee must establish a price override review process.

The designee must reasonably segregate fair value determination duties from portfolio management duties so that the portfolio manager’s influence cannot determine or effectively determine fair value. The SEC purposely allows portfolio management’s involvement due to their unique insights regarding the valuation of fund holdings. The SEC asserts that their approach to keeping the duties segregated “strikes the appropriate balance.”

Segregation of duty should be tailored to each fund’s facts and circumstances; however, the SEC suggests leveraging independent reporting chains, oversight arrangements, or separate monitoring systems and personnel. If portfolio management’s involvement is significant, the SEC states that the segregation process should be “appropriately rigorous and robust to mitigate” potential conflicts, such as providing independent voices as a check on potential conflicts.



RECORDKEEPING

Generally speaking, adopting new rule 31a-4 requires investment companies and BDCs to maintain appropriate documentation to support fair value determination. When designated, records of reports and other information provided to the board must be maintained and must include a specified list of investments or investment types.

Appropriate documentation should be sufficient for a third party, such as the SEC, that is uninvolved with preparing the fair value determinations to verify but not fully recreate them. The SEC states that documents can include the working papers of internally developed models, including the inputs, assumptions, and relevant supporting materials.

Because the SEC was concerned that designations could last longer than 5 years, the final rule states that records are generally required to be maintained for 6 years, the first 2 years of which should be easily accessible.

Funds, including internally managed funds designated to officers, are required to maintain records, but the designee bears the recordkeeping responsibility upon receiving board designation. In the event of a change in advisers, the SEC expects the fund board to ensure the appropriate transference of records to the new designee.

Compliance rule 31a-4 only requires funds or advisors to maintain records applicable to support fair value determinations. Recordkeeping of specific methods applied, assumptions, and inputs forming the basis of fair value determination in all cases is not required. Likewise, detailed records are not needed for a pricing service's applicable methods, assumptions, and inputs. Instead, appropriate documentation will consist of records related to the initial due diligence before selecting and recording ongoing monitoring and oversight. For instance, documentation that should be kept will include proof of consideration of the pricing service's methods, techniques, inputs, or assumptions for different asset classes and how they are affected by market condition changes. Another example would be to maintain work papers created while overseeing the pricing service (e.g., price challenges, stale price analysis (evaluation of whether a price quote that may be used to support fair value is sufficiently timely to be useful), etc.) or testing fair value methodologies (e.g., calibration, back-testing). Overall, the SEC expects that records kept will vary based on the subjectivity of inputs used (i.e., Level 2 vs. Level 3.)

Guidance from the SEC on Board Oversight

- ✓ Boards should approach oversight with a skeptical and objective view taking into account the fund's valuation risks, including conflicts, appropriateness of the fair value determination process and the skill and resources devoted to it.
- ✓ Oversight is an iterative process and seeks to identify potential issues and opportunities to improve the fair value process.
- ✓ The board's level of scrutiny should be based on the fund's valuation risks and should rise in proportion to the level of subjectivity required.
- ✓ A fund board's oversight should be a meaningful check on conflicts of interest of the designee and other service providers.
- ✓ Probe the appropriateness of processes including the financial resources, technology, staff, and expertise of the designee and the reasonableness of their reliance on other providers.
- ✓ A practice of oversight should consider the type, content, and frequency of reporting the board receives and can reasonably rely upon. It is incumbent on the board to request and review such information as necessary to remain adequately informed.
- ✓ If through its oversight the board becomes aware of material matters, they must inquire and take reasonable steps to see that they are addressed.

READILY AVAILABLE MARKET QUOTATIONS

As already stated within the SEC's Investment Company Act of 1940, readily available market quotes must be used to value securities. If market quotes are not readily available, then funds must be fair valued as determined in good faith by the board or the valuation designee.

The SEC defines a market quotation as readily available only when it is a quoted price (unadjusted) in active markets for identical investments accessible at the measurement date, provided that it will not be considered readily available if it is not reliable. This was not previously defined in the Act, but the SEC states that this applies in all contexts under the Act prospectively. This is consistent with Level 1 inputs under U.S. GAAP; however, Level 2 inputs are inconsistent with this concept as it uses quotes from inactive markets or inputs other than quoted prices. "Evaluated prices," "indications of interest," and "accommodation quotes" are not based upon unadjusted quoted prices from active markets for identical investments, so these are not considered readily available.

Certain pooled investment vehicles, such as mutual funds, that publish NAV daily are considered under GAAP as having observable Level 1 inputs and are therefore readily available. However, investment vehicles valued at their NAV as a practical expedient, such as private funds, are not considered readily available as their value is not based on unadjusted quoted prices. The SEC generally presumes that a quote would be "unreliable" under 2a-5 "where it would require adjustment under U.S. GAAP, or where U.S. GAAP would require consideration of additional inputs in determining" its value. For example, if an event has occurred since establishing value from the previous closing price that is "likely to have resulted in a change in such value," then the quote is unreliable.

The definition of "readily available" does not conform with that under rule 17a-7 that addresses "cross trades." The new definition may no longer allow previously qualified trades to occur. Consideration of potential revisions to 17a-7 is on the SEC's rulemaking agenda.

A QUOTE REQUIRING ADJUSTMENT UNDER U.S. GAAP, OR REQUIRING ADDITIONAL INPUTS TO DETERMINE ITS VALUE WOULD BE CONSIDERED UNRELIABLE.

RESCISSION OF PRIOR COMMISSION RELEASES

Previous guidance included in ASR 113 and ASR 118 is superseded or made redundant by rule 2a-5 and by the requirements under the current accounting and auditing standards and is therefore rescinded.

EXISTING COMMISSION GUIDANCE, STAFF NO-ACTION LETTERS, AND OTHER STAFF GUIDANCE

Certain SEC guidance, staff letters, and other staff guidance addressing a board's determination of fair value and other matters covered by the rules will be withdrawn or rescinded in connection with the adoption of 2a-5.

COMPLIANCE WITH RULES 2A-5 AND 31A-4 IS REQUIRED BY SEPTEMBER 8, 2022.

The SEC also confirmed that "good faith" is meant to be flexible as set out in U.S. GAAP and provides an example that "different funds, based on the various factors and market conditions considered could reasonably come to different conclusions on the price of a particular investment."

TRANSITION PERIOD

Funds must comply with rules 2a-5 and 31a-4 by September 8, 2022, which is 18 months from the effective date. Compliance on or before this date is required regardless of a fund's fiscal year-end or financial period. Funds may voluntarily comply in advance of the compliance date, provided that they do not also consider Commission and staff letter guidance that is scheduled to be rescinded.

WEIGHING THE CRITICAL IMPORTANCE OF SELECTING A DESIGNEE

The SEC suggests that boards will consider the following facts as they determine designating the fair value determination process:

- The number, amount, or allocation of investments for fair value determination
- The nature and complexity of the investments
- Fund type
- The designee's willingness to assume fair value determination duties and their resources
- Current practices

Fund boards that hold more investments and manage harder-to-value assets that need fair value analysis, and require frequent NAV calculations may be best suited to designate fair value responsibilities.

In selecting a designee, the board should examine the firm's client experience, representative expertise, the sufficiency of resources, and compensation structure to undertake the incremental responsibility.

As funds shift their current practices to comply with the new rules, some may find them materially different, requiring a significant cost investment to oversee the fair value determination process adequately. Under such circumstances, a board is well-advised to weigh the cost-benefit of leveraging a designee.

While the rule may bring solace with a more established, modernized framework, the final rule also delivers clarity—the board's role is expected to be active in fulfilling its fund oversight responsibilities.

By design and not chance, the SEC fully embedded active verbs throughout final rule 2a-5 and 31a-4 – designating, managing, selecting, assessing, applying, overseeing, testing, monitoring – frugal boards may find themselves taking on more risk without the benefit of a designee.



ABOUT VRC

VRC is a full-service, independent, global valuation and advisory services firm. Since 1975, we have provided objective, supportable conclusions of value to both domestic and international clients.

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