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# SEC MODERNIZES FRAMEWORK FOR FUND VALUATION PRACTICES

December 2020

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# SEC MODERNIZES FRAMEWORK FOR FUND VALUATION PRACTICES

Financial markets and fund investment practices have changed substantially since the US Securities and Exchange Commission (SEC) last addressed fund valuation comprehensively 50 years ago. In adopting Rule 2a-5 on December 3, the SEC has attempted to modernize the regulatory framework of fund valuation while rescinding much of the current existing fair valuation guidance. Under Rule 2a-5, determining fair value in good faith will require assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; and overseeing and evaluating any pricing services used.[1]

## KEY TAKEAWAYS

- Funds won't have to comply with the Rule until at least August 2022, but some funds may need a significant portion of that time to build the necessary compliance infrastructure.
- For many funds, the Rule may not materially affect their day-to-day valuation processes, but it will likely change board reporting.
- A board may designate the fund's adviser or, if the fund does not have an adviser, an officer or officers of the fund, as the "valuation designee" to perform determinations of fair value. A sub-adviser is not eligible to serve as valuation designee, nor is an administrator that is not the fund's adviser.
- Assuming a fund board appoints a "valuation designee," the board's role effectively will be limited to one of oversight and the Rule establishes a principles-based framework for such oversight.[2]
- Level 2 assets generally will be treated as having no readily available market quotation, which will require that a significant percentage of fixed income securities be fair valued, but it is clear that pricing services may be used to establish their fair values.
- The SEC stated that the Rule's definition of "readily available market quotations" will apply to all relevant provisions of the 1940 Act and rules thereunder, including Rule 17a-7, which could impact cross trade practices for certain asset classes.
- In response to comments regarding the concern that a recordkeeping failure may result in a fair valuation violation of Rule 2a-5, the recordkeeping requirements were moved into a new, separate rule: Rule 31a-4.
- In a change from the proposal, if a pricing service is used, detailed records relating to the specific methodologies the pricing service applied and the assumptions and inputs the pricing service considered will *not* be required to be maintained. Rather, the records related to the fund or valuation designee's initial due diligence investigation prior to selecting a pricing service and records from its ongoing monitoring and oversight of a pricing service will suffice.

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1 Good Faith Determinations of Fair Value, Investment Company Act Rel. No. 34128 (Dec. 3, 2020) (Adopting Release).

2 For unit investment trusts (UITs), because a UIT does not have a board of directors or adviser, a UIT's trustee, or – in a change from the proposal – the UIT's depositor, will conduct fair value determinations, subject to specific carve-outs for UITs deposited prior to the effective date of the Rule.

## BACKGROUND

The SEC on December 3 adopted a new fair valuation regulatory framework for registered investment companies and business development companies (BDCs): Rule 2a-5 under the Investment Company Act of 1940 (1940 Act). The SEC had first proposed the new regulatory framework on April 21, 2020, with comments requested on 72 questions – each with subparts – calling for industry input by July 21.[3] More than 60 comment letters were received by the SEC on the proposal. Although most commenters supported the SEC's goal of modernizing the regulatory framework for fund valuations, several requested additional flexibility regarding certain proposed requirements. In response to commenters, the SEC granted additional flexibility on certain aspects of the final Rule, although the core elements of the Rule are very similar to the proposal.

Section 22 of the 1940 Act, and the rules promulgated thereunder, impose certain requirements in connection with the pricing of a registered fund's redeemable securities. Rule 22c-1 requires a fund to sell, redeem, or repurchase its redeemable shares "at a price based on the current net asset value" of the shares, but in order for a fund's per-share price to be determined, the value of the fund's underlying securities and other assets must first be determined.

"Value" is defined in Section 2(a)(41) of the 1940 Act.[4] Relatedly, "current net asset value" is defined under a framework set forth in Section 2(a)(41) of the 1940 Act and Rule 2a-4 thereunder. Under Rule 2a-4, a fund must use one of two valuation processes to obtain a value for each of its underlying securities: current market value or fair value. Which valuation process the fund uses depends on whether a "market quotation" is "readily available" for that particular underlying security.

If a market quotation is readily available for the underlying security, then the underlying security is valued at current market value. In general, market quotations are considered "readily available" for securities that are traded on a national securities exchange or are otherwise considered Level 1 securities under US Generally Accepted Accounting Principles (GAAP). If a market quotation is not readily available for the underlying security, then the underlying security is valued at fair value, as determined in good faith by the fund's board.

For many fixed income securities, market quotations are not readily available, resulting in such securities having to be fair valued, typically by a pricing service. Even for Level 1 securities, market quotations may not be "readily available" during market closures, in thin markets, or if the validity of quotations is questionable. In such situations, a Level 1 security must be fair valued.[5] Fair value is the price that an arm's-length buyer would currently pay for the particular security, under current market conditions. Fair

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3 Good Faith Determinations of Fair Value, Investment Company Act Rel. No. 33845 (Apr. 21, 2020) (Proposing Release).

4 The definition of "value" set forth in Section 2(a)(41) also permits a fund's board to determine, in good faith, the value of a fund's securities issued by a controlled company, even if a market quotation is readily available for such securities, so long as the value provided by the board is not greater than the market value of the securities.

5 *See, e.g.*, December 1999 Letter to the Investment Company Institute Regarding Valuation, Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management (Dec. 8, 1999) (noting that market quotations are not readily available "when the exchanges or markets on which those securities trade do not open for trading for the entire day" and no other market prices are available); April 2001 Letter to the Investment Company Institute Regarding Valuation, Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management (Apr. 30, 2001) (noting that if the number of quotations available indicates that the market for a particular security is thin, then the board should give further consideration as to whether market quotations are "readily available.").

value cannot be based on an amount that may be obtained for the security at some future time. The SEC has long held the position that fair value is the price that a fund "might reasonably expect to receive upon its current sale."[6]

For years, the industry has sought more clarity in this area, as the last published comprehensive guidance on fund valuation was approximately 50 years ago.[7] Although market practice – and operational necessity – has long been that boards assign day-to-day valuation to a fund's officers, investment adviser, administrator, and other agents, boards have done so in accordance with a somewhat opaque (and outdated) patchwork of regulatory guidance and SEC staff positions. As the market has become more complex and inputs for valuation have become more voluminous, boards have sometimes struggled to interpret their responsibility for fund valuation under the current regulatory framework.

## THE FINAL RULE – RULE 2A-5

Rule 2a-5 sets forth the requirements for determining fair value in good faith with respect to a fund for purposes of Section 2(a)(41) of the 1940 Act and Rule 2a-4 thereunder. The SEC stated it was adopting Rule 2a-5 in response to the developments in markets and fund investment practices over the last 50 years, including developments in the accounting and auditing literature, the growing complexity of valuation, and intervening regulatory developments such as the development of ASC Topic 820 and Rule 38a-1 ("the compliance rule"). Additionally, the SEC believes that Rule 2a-5 is necessary as funds now invest a larger amount in a wider variety of securities and other instruments than before.[8]

As in the proposed rule, the Rule applies to all registered investment companies and business development companies (BDCs), regardless of their classification or sub-classification (e.g., open-end funds and closed-end funds), or their investment objectives or strategies (e.g., equity or fixed income; actively managed or index-tracking). Rule 2a-5 establishes minimum standards that the SEC believes are inherent in any good-faith fair value determination, as informed by current industry practices. Rule 2a-5 does not establish a single, one-size-fits-all approach to making good-faith fair value determinations, but rather establishes a principles-based framework for boards to use in creating their own tailored processes for making fair value determinations.[9]

Rule 2a-5, consistent with the 1940 Act, divides investments into two categories: those for which market quotations are readily available, and all others, which must be fair valued.[10] Under Rule 2a-5, a fund's board remains responsible for the fair value determinations required by statute, but may designate and oversee a "valuation designee" to perform fair value determinations. Where a board so designates fair value determinations to a valuation designee, the board must fulfill its continuing statutory obligations

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6 Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118 (Dec. 23, 1970).

7 *See* Statement Regarding "Restricted Securities," Accounting Series Release No. 113 (Oct. 21, 1969); Accounting for Investment Securities by Registered Investment Companies, *supra* note 6.

8 For example, funds that invest primarily in fixed income instruments (which may require fair value determinations for some or all of the portfolio assets) have expanded from around $800 billion in assets to over $4.5 trillion in just the last 20 years.

9 As discussed in *supra* note 2, for UITs either the UIT's trustee or depositor will conduct fair value determinations.

10 Although the Adopting Release discusses valuing securities using Level 1, Level 2, and Level 3 inputs, Rule 2a-5 does not, on its face, reference such valuation levels and does not distinguish between securities valued using Level 2 and Level 3 inputs. For more information on Level 1, Level 2, and Level 3 inputs, see the discussion of ASC (Accounting Standards Codification) Topic 820 in footnote 498 of the Adopting Release.

through active oversight of the valuation designee's performance.[11] To facilitate oversight, Rule 2a-5 also includes certain board reporting requirements.

## Determining Fair Value in Good Faith

By including the "valuation designee" definition in the final version of the Rule, the SEC effectively codifies the longstanding industry practice whereby a board typically adopts a valuation policy and then delegates or assigns day-to-day responsibility to the fund's adviser, which, in turn, may enlist sub-advisers, the administrator, pricing services and other vendors to assist with the valuation process, with the board retaining ultimate responsibility for that process. The clarity around the ability to delegate valuation responsibility should be a welcome development by the industry, given that it has, at times, been somewhat unclear as to whether and to what extent a board may delegate or assign its valuation function.[12]

In response to over 60 comment letters received, Rule 2a-5 was modified from the proposal to provide the board or the valuation designee with additional flexibility to exercise their judgment as opposed to mechanically applying a more rigid set of criteria. Accordingly, most fund complexes will be able to continue their current practices, with slight modifications to fit the Rule's specific requirements, which the board or the valuation designee may tailor to the particular facts and circumstances of the applicable funds.

1. ***Valuation Risk.*** The board or its valuation designee will be required to periodically assess and manage any material risks associated with fair valuation determinations ("valuation risks"), including material conflicts of interest. In the Adopting Release, the SEC identifies many potential sources of valuation risk, including the type of investment, the potential for market or sector shocks or dislocations, the extent to which a fair value methodology uses unobservable inputs (particularly if such inputs are provided by the valuation designee), the proportion of a fund's investments that are fair valued and their contribution to the fund's performance, reliance on service providers that have more limited experience or that are, in turn, relying on downstream service providers, and the risk that fair value methods are inappropriate or being inconsistently or incorrectly applied. This risk-based approach is similar to what the SEC has adopted for portfolio liquidity and fund investments in derivatives, signaling a clear pattern in the SEC's approach to regulating funds, which is conceptually similar to the approach taken by prudential bank regulators in recent years.

2. ***Valuation Methodologies.*** Fair value methodologies will have to be established and applied. This will require the board or the valuation designee, as applicable, after taking into account the fund's valuation risks, to select and consistently apply an appropriate methodology or methodologies for determining and calculating the fair value of fund investments. Such methodology or methodologies would be required to specify key inputs and assumptions specific

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11 For purposes of the Rule, "board" means either the fund's entire board of directors or a designated committee of such board composed of a majority of directors who are not interested persons of the fund.

12 *See, e.g.*, Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014) at n.890 ("[A]lthough a fund's directors cannot delegate their statutory duty to determine the fair value of fund portfolio securities, the board may appoint others, such as the fund's investment adviser or a valuation committee, to assist them in determining fair value."); *see also, id.* at n.898 and accompanying text ("Although a fund's directors cannot delegate their statutory duty to determine the fair value of fund portfolio securities for which market quotations are not readily available, the board may appoint others, such as the fund's investment adviser or a valuation committee, to assist them in determining fair value, and to make the actual calculations pursuant to the fair valuation methodologies previously approved by the directors.")

to applicable asset classes or investments.[13] Rule 2a-5 modifies the proposed rule by (1) adding that the selected methodologies for fund investments may be changed by the board or the valuation designee if different methodologies are equally or more representative of the fair value of the investments, and (2) removing the requirement to specify methodologies that will apply to new types of investments in which the fund intends to, but does not currently, invest. The Adopting Release also clarifies that the requirement for consistent application of a methodology does not mean that such methodology must be locked in place; rather, the use of the word "consistent" serves to eliminate the potential for opportunistic deployment of whichever methodology will achieve the most favorable outcome, which could reflect a conflict of interest. The proposed requirement to specify predetermined methodologies for hypothetical future investments was identified as potentially overly burdensome, and therefore was omitted from the final version of the Rule.

The appropriateness and accuracy of the selected methodologies will also have to be periodically reviewed, and the selected methodologies adjusted or changed, as necessary. The Rule clarifies that such periodic review may include modifying an existing methodology or changing to a new methodology entirely. The board or the valuation designee will also have to monitor for circumstances that necessitate the use of fair value. The Rule will not require the board or the valuation designee to establish specific criteria for determining when market quotations are no longer reliable and, therefore, not readily available, but instead the Rule provides the board or the valuation designee with flexibility to consider the full range of conditions that may affect reliability.

3. ***Testing Methodologies.*** The board or the valuation designee will have to test the appropriateness and accuracy of fair value methodologies. Testing methods used, and the frequency of testing, will also have to be established as part of the board's or the valuation designee's process. The final Rule provides flexibility with respect to the testing methods used; however, the SEC noted in particular that the results of calibration and back-testing (i.e., comparing determined fair values against observed transactions or other market information) could help identify trends and could assist in identifying issues with methodologies applied by service providers, including poor performance.

4. ***Pricing Services.*** Pricing service providers, if used, will have to be overseen, which must include a process for approving, monitoring, and evaluating pricing service providers, and a process for initiating price challenges. The Adopting Release provides that the board or the valuation designee should consider the qualifications, experience, and history of the pricing service; the methods, techniques, inputs, and assumptions used by the pricing service for different classes of holdings during different market conditions; the quality of the pricing information provided by the service and the extent to which the service determines its pricing information as close as possible to the time as of which the fund calculates its net asset value; the pricing service's process for considering challenges; potential conflicts of interest; and the testing processes used by the pricing service. In a change from the proposal, Rule 2a-5 requires funds to establish a *process* for initiating a price challenge rather than establishing *criteria* that would automatically trigger a price challenge. The Adopting Release notes that such a process should generally outline the circumstances under which a price challenge should be initiated.

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[13] The Adopting Release confirms that an appropriate methodology must be consistent with those used to prepare the fund's financial statements under US GAAP. A valuation methodology that is inconsistent with such principals would be presumptively misleading or inaccurate.

5. ***Written Policies and Procedures.*** Rule 2a-5 does not include the proposal's requirement to adopt written policies and procedures. Instead, the SEC will leverage existing compliance requirements with respect to fair valuation. The Adopting Release notes that Rule 38a-1 requires a fund's board, its adviser, and other specified service providers to adopt policies and procedures reasonably designed to prevent violations of the federal securities laws and, accordingly, with the adoption of Rule 2a-5 and Rule 31a-4, such policies and procedures to determine the fair value of fund investments will already be required by Rule 38a-1, and any additional provisions would be duplicative. A fund's compliance policies and procedures, in other words, will likely have to be amended to account for the adoption of the Rule 2a-5 and Rule 31a-4.[14]

## Performance of Fair Value Determinations

Under the 1940 Act, securities and assets without readily available market quotations are valued at fair value as determined in good faith by a fund's board of directors or trustees. Rule 2a-5 confirms that a board can make this determination on its own, but also permits – consistent with widespread current market practices – a board to designate the performance of fair value determinations to a fund's adviser, as a valuation designee subject to the board's oversight.[15]

The SEC noted in the Adopting Release that it continues to believe that allocating day-to-day responsibilities to a designee is appropriate and consistent with the 1940 Act.[16] If a board designates the performance of fair value determinations to a valuation designee, the board will be required to comply with certain conditions, including:

- ***Oversight and Reporting.*** A board will be required to oversee the valuation designee and review periodic reports from the valuation designee. The SEC expects a board, in providing oversight of the valuation designee, to request follow-up information on and take reasonable steps to determine that matters identified in the valuation designee's reports are addressed; identify, monitor, and manage potential conflicts of interest for the valuation designee; and understand the role and any potential conflicts of any service provider the valuation designee uses in its fair valuation process.

  At least quarterly, the valuation designee will be required to provide the board with any materials requested by the board and a summary or description of any material fair value matters, which must include (1) any material changes in the valuation designee's assessment and management of valuation risk, its own conflicts of interests and conflicts of interests of service providers involved in the fair value process; (2) any material changes to or deviations from the valuation

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[14] We note that Rule 38a-1 has increasingly become a conduit through which the SEC can question board processes. Further, it is not without precedent that the SEC has used Rule 38a-1 as a means of attacking independent directors with respect to issues of fund valuation. *See* In the Matter of J. Kenneth Alderman, et al., Investment Company Act Rel. No. 30,557 (June 13, 2013) (alleging that directors' conduct caused funds to violate Rule 38a-1).

[15] A valuation designee may only be the fund's adviser or, if the fund is internally managed, an officer or officers of the fund. In a change from the Proposing Release, a board may not delegate the performance of fair valuation determinations to a fund's sub-adviser, as the SEC believes that it is important that the valuation designee have a direct relationship with the fund. Further, the SEC declined to expand valuation designee eligibility beyond the fund's adviser, e.g., to include an administrator that is not the fund's adviser, as it believes that the adviser's fiduciary duty is critical to the adviser's ability to make fair value determinations. These other service providers, including sub-advisers, may however assist the valuation designee in the fair valuation process, so long as the valuation designee is ultimately responsible for fair value determinations. This aspect of the Rule might be problematic for a fund whose adviser's responsibilities are limited to investment management.

[16] In response to comments to the Proposing Release, the SEC adopted the term "valuation designee" in lieu of "assignee" to avoid any suggestion that a board "has completely delegated the entire valuation function and related obligations to the adviser."

designee's fair value methodologies; and (3) any changes to the valuation designee's process for selecting and overseeing pricing services. The valuation designee will also be required to provide the board with annual reports regarding the valuation designee's assessment of the adequacy and effectiveness of the fair valuation process. The annual reports must include a summary of fair value methodologies, testing results, and an assessment of the adequacy of resources allocated to the fair valuation process.

Matters associated with the fair value process that materially affect (or could materially affect) the fair value of the fund's portfolio investments must be reported to the board within a timeframe determined by the board, but no later than five business days after the designee has become aware of such matter's materiality. This would include significant deficiencies or material weaknesses in the design or implementation of the designee's fair value determination process, or material changes in the fund's valuation risks. If the valuation designee is not able to determine the materiality of a matter after 20 business days of becoming aware of the matter, the valuation designee must notify the board of the matter and the designee's ongoing evaluation of the matter.[17]

- ***Responsibilities and Functions.*** If a board designates the performance of fair valuation determinations to a valuation designee, the valuation designee must specify the titles and functions of the persons responsible for fair value determinations, which must be reasonably segregated from portfolio management. Because fund portfolio managers may be the most knowledgeable persons regarding a fund's holdings, the SEC recognized in the Adopting Release that the designee may require portfolio manager input for determining fair value; however, because portfolio managers are often compensated based – at least in part – on a fund's performance, their incentives may not be fully aligned with accurately determining fair value and, therefore, portfolio managers may not make fair value determinations and may not exert a substantial influence on fair value determinations. Rule 2a-5 will require a valuation designee to adopt an appropriate segregation process that is tailored to a fund's particular circumstances, and if a fund's portfolio manager may have a significant influence on the fair value process, the valuation designee should adopt a more rigorous and robust segregation process. In such instances, the valuation designee could enlist independent input from outside sources, such as the fund's administrator, to balance out the portfolio manager's influence.

## Readily Available Market Quotations & Potential Narrowing of Cross Trades

Under the 1940 Act, fund investments must be fair valued where market quotations are not "readily available." Paragraph (c) of Rule 2a-5 defines a market quotation as "readily available" only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date.[18] Rule 2a-5 also clarifies that a quotation is not readily available if it is not reliable. The Adopting Release provides that indications of interest and accommodation quotes would

[17] The SEC notes in the Adopting Release that it does not expect designees to always be able to determine whether a matter is material within the five-business day period, but states that a designee should act promptly in making determinations of materiality and not take the 20 business day period as a matter of course.

[18] The SEC, however agreed that an investment in a mutual fund or similar structure that has a readily determinable fair value per share that is determined and published, and is the basis for current transactions, such as a daily NAV for mutual fund shares, would generally be consistent with the definition of having "readily available" market quotations.

not be considered "readily available market quotations." This approach is largely consistent with the approach under the current regime.

Related to the issue of readily available market quotations, the SEC also addressed the topic of cross trades in the Adopting Release. Rule 17a-7 under the 1940 Act permits certain affiliates of a fund to transact in a principal cross trade as long as, among other conditions, there is a readily available market quotation for the security that is the subject of the trade. Rule 17a-7 cross trades are a common practice in the registered fund space, which led several commenters to question whether the adoption of the Rule could impact existing market practices, particularly with respect to cross trades of fixed income securities. In the Adopting Release, the SEC stated that the Rule's definition of readily available market quotations will apply "in all contexts" under the 1940 Act, including Rule 17a-7, noting that the SEC, when it adopted Rule 17a-7 in 1981, had referred to the concept of readily available market quotations in Section 2(a)(41) of the 1940 Act and Rule 2a-4. The SEC acknowledged that certain market participants may need to conform their practices to the new Rule given that certain securities that had previously been considered to have a readily available market quotation may not meet the definition adopted in the Rule and, accordingly, may not be eligible for Rule 17a-7 cross trades. The SEC also noted that the SEC staff currently is considering whether to withdraw letters that it has issued to registrants on the topic of Rule 17a-7 cross trades, and invited public comment on Rule 17a-7 as part of the SEC's current rulemaking agenda. As a result, fund managers – particularly in the fixed income space – may want to carefully consider the potential impact of the Rule on their cross trade practices and monitor for any further regulatory developments, such as the withdrawal of relevant no-action letters.

## Recordkeeping

The SEC also adopted Rule 31a-4, which will require funds to maintain additional records relevant to the valuation designee, including the reports provided to the board by the valuation designee and a list of the investments (or investment types) whose fair valuation has been designated. Rule 31a-4 is substantially similar to the recordkeeping obligations that were originally proposed for inclusion in Rule 2a-5.[19] In the Adopting Release, the SEC acknowledged several current practices that advisory personnel use to support fair value determinations and indicated that the attendant records produced are the types of records that would be sufficient for purposes of compliance with Rule 31a-4.[20]

## Rescission of Prior SEC and Staff Guidance

As a result of Rule 2a-5's modernized approach to fund valuation, the SEC will rescind, upon Rule 2a-5's compliance date, the two seminal accounting releases of the registered fund space: Accounting Series Release 113 (ASR 113) and Accounting Series Release 118 (ASR 118), which were published in October 1969 and December 1970, respectively, and represent the most recent comprehensive guidance provided by the SEC on, among other things, how to determine fair value for restricted securities.

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[19] The SEC explained in the Adopting Release that the decision to move this provision to its own rule reflects an effort to centralize investment company recordkeeping provisions and ensure that a failure to keep the required records does not result in a determination that a board did not fulfil its statutory duty of fair valuation in good faith.

[20] The SEC noted that the content of such records should include documentation that would allow a third party not involved in the preparation of the fair value determination to verify, rather than recreate, the fair value determination. With respect to records relating to the methodologies applied by pricing services, the SEC clarified that appropriate documentation to support a fair value determination that includes inputs from pricing services should include records relating to the fund or the valuation designee's *initial* due diligence investigation prior to selecting the pricing service, as well as records evidencing its ongoing monitoring and oversight of the pricing service.

In addition, the SEC stated that certain staff letters and other staff guidance addressing fund valuation matters covered by Rule 2a-5 will be rescinded or withdrawn in connection with the adoption of the Rule. Among the seven specific items identified in the Adopting Release[21] are the two letters issued to the Investment Company Institute in 1999 and 2001. This approach of not only modernizing but also streamlining the regulatory space by the removal of outdated or redundant guidance is consistent with the approach taken the by the SEC in other recent rules, such as the recently adopted derivatives rule.

### Transition Period

Rules 2a-5 and 31a-4 will be effective 60 days after publication of the Rules in the *Federal Register*. Thereafter, funds will have 18 months to comply with the Rules. A fund may choose to comply with the Rules prior to the compliance date, but would not also be permitted to rely on any prior guidance that the SEC will be rescinding. In other words, a fund cannot selectively rely on both the new Rules and the current framework during the compliance period.

## NEXT STEPS

Although Rule 2a-5 and the Adopting Release represent a substantial modernization of the regulation of fund valuation, the adopted framework is flexible enough that many current market practices, and possibly most of a fund's day-to-day valuation practices, can be maintained. Even so, implementation of policies and procedures reasonably designed to ensure compliance with the Rule will likely be a substantial task because in most cases all current fair valuation processes would have to be revisited and potentially modernized, even if only partially. For example, pricing service relationships will need to be reviewed to determine if they satisfy the terms of Rule 2a-5 and the guidance in the Adopting Release. Similarly, if an affiliate of the adviser is currently performing a substantial portion of the day-to-day valuation work, those relationships may need to be formalized and documented to reflect the primary responsibility of the valuation designee and the specific roles of such affiliates that provide input to the valuation designee. If an administrator is currently performing fair valuation functions, processes will likely need to be restructured so that, for example, the adviser serves as the valuation designee, but is assisted by the administrator.

Accordingly, fund managers may find it useful to conduct an inventory of their pricing services in the context of particular asset classes in which their funds invest. Fund managers may then also want to consider whether to create a multidisciplinary team – fund accounting, portfolio management, operations, and compliance – to assess whether relationships with pricing vendors should be modified or terminated in the context of the Rule, and then outline a process for selecting and overseeing pricing services. In many respects, this diligence on pricing services is reflective of current market practices, however the SEC's recent enforcement settlement against a securities pricing service may spur funds to consider

[21] The SEC clarified in the Adopting Release that to the extent that any guidance is inconsistent with or conflicts with the Rules, such guidance is superseded by the Rules even if it is not specifically identified in the Adopting Release. The following seven items were specifically identified in the Adopting Release: (1) Paul Revere Investors, Inc., Feb. 21, 1973; (2) The Putnam Growth Fund and Putnam International Equities Fund, Inc., Jan. 23, 1981; (3) Form N-7 for Registration of Unit Investment Trusts under the Securities Act of 1933 and the Investment Company Act of 1940, Investment Company Act Release No. 15612, Appendix B, Guide 2, Mar. 17, 1987; (4) Investment Company Institute, Dec. 8, 1999; (5) Investment Company Institute, Apr. 30, 2001; (6) Last paragraph of Section III.D.2.(a) and the entirety of Section III.D.2.(b) of the 2014 Money Market Fund Release, July 23, 2014; (7) Valuation Guidance Frequently Asked Questions (FAQ 1 only), 2014. In contrast to the Proposing Release, the Adopting Release explicitly rescinds certain statements made by the SEC in the 2014 money market fund adopting release regarding a board's inability to delegate its statutory duty.

whether to make adjustments to their oversight of pricing vendors.[22] Chief compliance officers and their compliance teams will also need to coordinate enhancements to funds' compliance manuals to operationalize both Rule 2a-5 – including provisions of ancillary application of the concept of "readily available market quotations," such as Rule 17a-7 – and the related recordkeeping requirements of Rule 31a-4, which may require coordination with fund administrators.

Fund boards should also consider whether to implement formal or informal reporting timelines for updates on the implementation of the new Rule. Fund boards also may want to review the information that they currently receive with respect to valuation to consider whether those reports and data sets should be streamlined or enhanced in response to the Rule.

The risk-based principles set forth in the Rule and accompanying Adopting Release will likely permit most fund complexes to continue their day-to-day valuation business as usual, after undertaking an inventory of the Rule and engaging in an assessment of current practices with their boards. For most fund complexes, the end result may not be much different than the procedures and practices currently implemented, but the process of assessing a fund's current procedures for compliance with the new Rule still could be a significant lift over the next 20–22 months (depending on when the Rule is published in the *Federal Register*).

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[22] *See* In the Matter of ICE Data Pricing & Reference Data, LLC, Investment Advisers Act Rel. No. 5643 (Dec. 9, 2020) (alleging that global pricing services provider's policies and procedures of for single broker quotes were not reasonably designed or implemented, which violated Section 206(4) of Investment Advisers Act and Rule 206(4)-7 thereunder).

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