

## SEC Passes New Rule 2a-5 Regarding Fair Valuation

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On Dec. 3, 2020, the Securities and Exchange Commission (SEC) announced it adopted a [new Rule 2a-5](#) under the Investment Company Act of 1940 (Act). It had been over 50 years since the SEC had last comprehensively addressed valuation rules with respect to the fair value of investments held by registered investment companies (funds). The new rule is intended to address valuation practices and the role of the board of directors with respect to the good faith fair valuation of the investments of a fund. The good faith determination of a security's fair value under the new rule will involve (i) assessing and managing material risks associated with fair value determinations; (ii) selecting, applying, and testing fair value methodologies; and (iii) overseeing and evaluating any pricing services used. The new rule allows a fund's board of directors to designate certain parties to perform the fair value determinations for some or all of the fund's investments. This designation will be subject to board oversight and certain reporting and other requirements designed to allow the board to effectively oversee the designee's fair value determinations. The new rule also defines when market quotations are readily available under the Act, provides recordkeeping requirements for the fair value determinations, and rescinds previously issued guidance on the role of the board of directors in determining fair value and the accounting and auditing of fund investments. While the new rule applies only to registered investment companies, some of the concepts may be considered for use by private funds. The new rule is effective 60 days after it is published in the Federal Register.

### Background

The Act requires funds to value their portfolio investments using the market value of their portfolio securities when market quotations are "readily available," and, when a market quotation for a portfolio security is not readily available, by using the security's fair value, as determined in good faith by the fund's board. While proper valuation has been an area of focus for the SEC, there has been little comprehensive guidance regarding how boards are to go about ensuring proper valuation of a fund's securities.

Under section 2(a)(41) of the Act, if a market quotation is readily available for a portfolio security, it must be valued at the market value. Conversely, if market quotations are "not readily available," a portfolio security value must be fair valued as determined in good faith by the board (or the valuation designee under the new rule). The new rule provides that a market quotation is readily available with respect to a security 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

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will not be readily available if it is not reliable.”

## Assessing and Managing Material Risks

The new rule requires any material risks associated with the determination of the fair value of the fund’s investments, including material conflicts of interest, must be assessed periodically and the identified valuation risks must be managed. However, the new rule does not identify other specific valuation risks that may need to be addressed under this requirement or establish a specific re-assessment frequency.

In the adopting release for the new rule, the SEC set forth a non-exhaustive list of sources or types of valuation risk:

- the types of investments held or intended to be held by the fund and the characteristics of those investments;
- potential market or sector shocks or dislocations and other types of disruptions that may affect a valuation designee’s or a third-party’s ability to operate;
- the extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the valuation designee;
- the proportion of the fund’s investments that are fair valued as determined in good faith, and their contribution to the fund’s returns;
- reliance on service providers that have more limited expertise in relevant asset classes; the use of fair value methodologies that rely on inputs from third-party service providers; and the extent to which third-party service providers rely on their own service providers (so-called “fourth-party” risks); and
- the risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.

## Fair Value Methodologies and Testing

The new rule provides that fair value, as determined in good faith, requires the board or valuation designee, as applicable, to establish and apply fair value methodologies. To satisfy this requirement, a board or valuation designee, as applicable, must:

- *select and apply appropriate fair value methodologies.* The new rule requires the board or valuation designee, as applicable, to select and apply in a consistent manner an appropriate methodology for determining the fair value of fund investments. The board or valuation designee, as applicable, will have to specify the key inputs and assumptions specific to each asset class or portfolio holding. The selected methodologies for fund investments may be changed if different methodologies are equally or more representative of the fair value of the investments. The methodology is not required to specify the methodology that will apply to new types of investments in which the fund intends to invest. The requirement that the methodology be applied consistently is not meant to limit a board or valuation designee, as applicable, from using an appropriate methodology to fair value an investment, even if other

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investments within the same “asset class” are fair valued using a different appropriate methodology. The SEC’s position is that an appropriate methodology must be consistent with those used to prepare the fund’s financial statements and, thus, be consistent with the principles of the valuation approaches laid out in ASC Topic 820.

- *periodically review the appropriateness and accuracy of the methodologies selected and make any necessary changes or adjustments thereto.* The new rule requires a board or valuation designee to review periodically the selected fair value methodologies for appropriateness and accuracy, and to make changes or adjustments to the methodologies where necessary.
- *monitor for circumstances that may necessitate the use of fair value.* The new rule also requires the board or valuation designee, as applicable, to monitor for circumstances that may necessitate the use of fair value as determined in good faith.

The new rule also requires the testing of the appropriateness and accuracy of the methodologies used to calculate fair value. This requirement is designed to help ensure that the selected fair value methodologies are appropriate and that adjustments to the methodologies are made where necessary. The new rule requires the board or valuation designee, as applicable, to identify the testing methods to be used and the minimum frequency with which such testing methods are used, but will not require particular testing methods or a specific minimum frequency for the testing.

The new rule does not specifically require that a board adopt separate fair value policies and procedures because Rule 38a-1 already requires a fund’s board to approve the fund’s policies and procedures as well as those of certain service providers, based upon a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal securities laws, which would include Rules 2a-5 and 31a-4.

## **Pricing Services**

The new rule provides that a determination of fair value in good faith requires the oversight and evaluation of pricing services, where used. For funds that use pricing services, the new rule requires that the board or valuation designee, as applicable, establish a process for approving, monitoring, and evaluating each pricing service provider. In addition, the new rule requires that the board or valuation designee, as applicable, establish a process for initiating price challenges as appropriate. The board or valuation designee, as applicable, may challenge a price when, for example, the fund’s board or valuation designee, as applicable, does not have a good faith basis for believing that the pricing service’s pricing methodologies produce prices that reflect fair value.

In selecting a pricing service, the fund’s board or valuation designee generally should take into consideration factors such as: (i) the qualifications, experience, and history of the pricing service; (ii) the valuation methods or techniques, inputs, and assumptions used by the pricing service for different classes of holdings, and how they are affected as market conditions change; (iii) 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; (iv) the pricing service’s process for considering price challenges, including how the pricing service incorporates information received from price challenges into its pricing information; (v) the pricing service’s actual and potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and (vi) the testing processes used by the pricing service.

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## Valuation Designee

The new rule permits a fund's board to designate a "valuation designee" to perform fair value determinations. Previously, boards were not allowed to delegate this responsibility and took ultimate responsibility themselves. The valuation designee can be the adviser of the fund (or, for internally managed funds, an officer). The new rule does not allow boards to designate the performance of fair value determinations to fund sub-advisors. However, valuation designees can seek sub-advisor assistance as they deem appropriate.

When a board designates a valuation designee for some or all of the fund's investments, the new rule requires the board to oversee the valuation designee's performance of fair value determinations, and, to that end, includes certain reporting and other requirements. Under the new rule, while the board remains responsible for the fair value determinations required by the statute, where the board designates a valuation designee to perform fair value determinations, the board must still fulfill the continuing statutory obligations that it has not delegated or cannot delegate.

*Active Oversight.* Active oversight of the valuation designee, by actively probing information presented, asking questions, and seeking relevant information. The SEC believes that boards are not providing appropriate oversight if they simply rely on information presented to them without this active oversight. However, the new rule does not require boards to ratify fair value determinations made by the valuation designee.

Boards overseeing a valuation designee would be expected to use the appropriate level of scrutiny based on the fund's valuation risk, including the extent to which the fair value of the fund's investments depend on subjective inputs. A board must also seek to identify potential conflicts of interest, monitoring such conflicts, and taking reasonable steps to manage such conflicts.

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 and should consider the valuation designee's compliance capabilities that support the fund's fair value processes.

While a board may reasonably rely on the information provided to it in summaries and other materials provided by the valuation designee and other service providers in conducting appropriate oversight, the board must request and review such information as may be necessary to be informed of the valuation designee's process for determining the fair value of the fund's portfolio. In addition, if the board becomes aware of material matters, the board must inquire about such matters and take reasonable steps to see that they are addressed. The SEC noted that material matters in this context 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. For example, material matters include significant deficiencies or material weaknesses in internal control over financial reporting related to fair value determinations that have been identified and generally would include those items that "could have materially affected" the fair value of the fund's investments. Other examples of material matters noted in the release were changes to a pricing service affiliated with the valuation designee or material changes to or deviations from methodologies, including changes to critical inputs or assumptions, material changes to the selection or oversight of pricing services, a pattern of price challenges or overrides over time that raise concerns with the overall valuation process.

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Reporting. The new rule requires the valuation designee to make both annual and quarterly written reports to the board. Specifically:

- *Quarterly Reports.* The valuation designee must provide at least quarterly, in writing, (1) any reports or materials requested by the board related to the fair value of the portfolio or the valuation designee's process for fair valuing fund investments and (2) a summary or description of material fair value matters (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) that occurred in the prior quarter. This summary or description must include (1) any material changes in the assessment and management of valuation risks, including any material changes in conflicts of interest of the valuation designee (and any other service provider), (2) any material changes to, or material deviations from, the fair value methodologies, and (3) 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.
- *Annual Reports.* The valuation designee must provide at least annually, 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. This annual report must include a summary of the results of the testing of fair value methodologies required under the new rule and an assessment of the adequacy of resources allocated to the process for determining the fair value of designated investments, including any material changes to the roles or functions of the persons responsible for determining fair value.
- *Prompt Notification and Reporting.* The valuation designee is required to provide in writing the occurrence of matters that materially affect the fair value of the investments within a time period determined by the board, but no later than five business days after the valuation designee becomes aware of the material matter. The purpose of this requirement is to ensure that boards receive timely information that demands their immediate attention.

Specification and Segregation of Functions. The new rule requires the valuation designee to specify the titles of the persons responsible for determining the fair value of the designated investments, including by specifying the particular functions for which the persons identified are responsible. The valuation designee must identify the specific personnel with duties associated with price challenges, including those with the authority to override a price, along with the roles and responsibilities of such persons. The valuation designee is also required to establish a process for the review of price overrides. In addition, the valuation designee must take steps to reasonably segregate fair value determinations from the portfolio management of the fund so that the portfolio manager may not determine, or effectively determine by exerting substantial influence on, the fair values ascribed to portfolio investments due to potential conflicts of interest.

## **Recordkeeping**

The SEC also adopted new rule 31a-4 that applies to registered investment companies regarding the recordkeeping requirements associated with Rule 2a-5. Rule 31a-4 requires funds or their advisers to maintain appropriate documentation to support fair value determinations. The SEC believes that the requirement to maintain appropriate documentation to support fair value determinations should include documentation that would be sufficient for a third party, such as the SEC's staff, not involved in the preparation of the fair value determinations to verify, but not fully recreate, the fair value

determination. The fund will be required to maintain these records unless the board has designated the adviser as the valuation designee. If the adviser has been designated the valuation designee, then the investment adviser will maintain the records. In addition, Rule 31a-4 requires that, when there is a valuation designee, the reports and other information provided to the board by the valuation designee must include a specified list of the investments or investment types for which the valuation designee has been designated. These records will generally be required to be maintained for six years, the first two in an easily accessible place.

## Previous Guidance Rescinded

The SEC rescinded ASR 113 and ASR 118 in their entirety their content is superseded or made redundant by the adoption of the new rule and by the requirements under the current accounting and auditing standards.

In addition to the rescission of ASR 113 and ASR 118, certain other 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 the new rule. A list of rescinded guidance is provided below:

Name	Date	Topic
Paul Revere Investors, Inc.	Feb. 21, 1973	Delegation to a board valuation committee
The Putnam Growth Fund and Putnam International Equities Fund, Inc.	Jan. 23, 1981	Fair value of portfolio securities which trade on a closed foreign exchange.
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	Fair value for UITs to be determined by the trustee or its appointed person.
Investment Company Institute	Dec. 8, 1999	Fair value generally
Investment Company Institute	Apr. 30, 2001	Fair value generally
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	Guidance regarding the fair value of thinly traded securities and use of pricing services.
Valuation Guidance Frequently Asked Questions (FAQ 1 only)	2014	Fund directors' responsibilities when determining whether an evaluated price provided by a pricing service, or some other price, constitutes fair value.

## Compliance Date

The compliance date will be 18 months following the effective date of Rule 2a-5 and Rule 31a-4.

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