

SEC Modernizes Framework for Registered Fund Valuation Practices under Investment Company Act

December 7, 2020

In a December 3, 2020 [release](#) (the “**Adopting Release**”), the Securities and Exchange Commission (the “**SEC**”) adopted new Rule 2a-5 under the Investment Company Act of 1940, as amended (the “**Investment Company Act**”). The rule establishes a new framework for good-faith determinations of the fair value of a registered fund’s investments under Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder.¹ Under Rule 2a-5, good faith determinations of fair value would require certain functions to be performed, such as:

- Assessing and managing material risks associated with fair value determinations, including material conflicts of interest;
- Selecting, applying and testing fair value methodologies; and
- Overseeing and evaluating any pricing services used.

According to the Adopting Release and original rule proposal,² Rule 2a-5 is designed to address market developments in registered fund valuation practices, including the greater variety of asset classes held by registered funds, enhanced availability and volume of data used in valuation determinations, and increased use of third-party pricing services. The Adopting Release also recognizes the important role and expertise provided by registered fund advisers in the valuation process. Notably, Rule 2a-5 expressly permits a fund board to designate the fund’s adviser (or an officer or officers of the fund if the fund is internally managed) to perform the valuation functions required under the rule, subject to additional recordkeeping, reporting and other requirements designed to facilitate the board’s oversight of the designee’s fair value determinations. In addition, Rule 2a-5 requires a registered fund’s valuation designee to reasonably segregate fair value determinations from the portfolio management of the fund. Rule 2a-5 also defines when a market quotation would be considered “readily available” for purposes of Section 2(a)(41), and provides that for a registered fund that is a unit investment trust, the required valuation functions under the rule would be performed by the fund’s trustee or depositor.

In connection with the adoption of Rule 2a-5, the SEC also adopted Rule 31a-4 under the Investment Company Act, which requires a registered fund (or its adviser, if the fund board designated its adviser to perform fair value determinations under Rule 2a-5) to maintain appropriate documentation to support fair value determinations, and certain other documentation related to the designation of a valuation designee, if applicable.

With the adoption of Rule 2a-5, the SEC has rescinded prior guidance in Accounting Series Release 113, SEC Release No. IC-5847 (Oct. 21, 1969), Accounting Series Release 118, SEC Release No. IC-6295 (Dec. 23, 1970) and certain other SEC staff letters relating to valuation that would be superseded or inconsistent with the rule.

The SEC provided for a transition period of 18 months from the effective date of the rules to provide time

¹ Davis Polk is preparing a Regulatory Update which will discuss the new rule and will be published shortly.

² *Good Faith Determinations of Fair Value*, SEC Release No. IC-33845 (April 21, 2020).

for registered funds and valuation designees to prepare for compliance.

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