



Mutual fund directors and investment advisers digest

Risk-based governance and reporting: SEC Adopts Framework for Fund Valuation Practices

On December 3, 2020, the US Securities and Exchange Commission (SEC) adopted rule 2a-5 and rule 31a-4 under the Investment Company Act of 1940 (1940 Act). As adopted, the final rules seek to provide a common fund valuation framework across all fund groups, including business development companies. While confirming that a fund's board can make fair value determinations itself, rule 2a-5 also permits a board to designate such determination to a valuation designee, primarily the investment adviser, and fulfill its statutory responsibilities through active oversight. Throughout the 210-page adopting release, the SEC discussed their deliberation of over 60 industry comment letters, making thoughtful observations, rebuttals and, in some cases, agreement that resulted in changes to the final rule. Two notable industry comments that were not changed by the SEC were the definition of a "readily available market quote" (effectively scoping in all level 2 and 3 securities into the rule) and the SEC did not think that it was appropriate to recast rule 2a-5 as a safe harbor. While we believe that the final framework for fund valuation practices aligns with several practices today, we anticipate that many fund groups will have a heavy lift to comply with the rules. No doubt, certain formalities and board responsibilities introduced by the final rules will change the nature of valuation-related communications between boards and the investment advisers as well as other industry stakeholders including pricing services, the SEC, auditors, and fund administrators.

Key takeaways and observations

In the SEC's view, fair valuation in good faith with respect to the 1940 Act requires that boards:

- Periodically assess and manage valuation risks associated with fair value determinations (including material conflicts of interest);
- Establish and apply fair value methodologies;
- Test fair value methodologies for appropriateness and accuracy¹;

- Evaluate and oversee pricing services; and
- Adopt and implement fair value policies and procedures under the compliance rule².

Boards can designate these activities to a valuation designee (primarily the investment adviser) so long as the board continues to provide active oversight of the valuation process. The SEC made it clear that "*in our view appropriate oversight cannot be a passive activity. Directors should ask questions and seek*

relevant information". As noted, both the proposed and final rule identified certain information that must be provided and reported (periodically and promptly) to the board under this framework; however, the final rule scaled back on some of the prescriptive nature of the information required.

Rule 2a-5, in situations where the board designates a valuation designee, requires quarterly valuation reporting.

Key takeaways and observations (continued)

Such quarterly reports in writing need to include:

- Any reports or materials requested by the board related to the fair value of investments
- A summary or description of material fair value matters that occurred in the prior quarter, including:
 - Any material changes in the assessment and management of material valuation risks, including any material changes in conflicts of interest
 - Any material changes or deviations of established fair value methodologies
 - Any material changes to or material events in the selection and oversight process for pricing services used.

On an annual basis, the valuation designee must also provide the board in writing:

- An assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of the designated portfolio of investments including:
 - A summary of the results of the testing of fair value methodologies
 - An assessment of the adequacy of resources allocated to the process for determining fair value, including any material changes to the roles or functions of the person responsible for determining fair value.

Under the final rule the valuation designee will also be required to promptly notify the board, at a time determined by the board but no more than five business days after the designee becomes aware, of material matters that may affect the fair value of the portfolio of investments such as a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process or material errors in the calculation of net asset value. The SEC's final rule also clarified several definitional matters and rescinds previously issued guidance that has been rendered obsolete.³

As noted, the SEC did provide some definitional guidance on material matters and material errors. For material matters, the SEC focused on significant deficiencies and material weaknesses in the design or effectiveness of the valuation designee's fair valuation determination process. For material errors in the calculation of net asset value (presumably related to valuation matters), the SEC, albeit passing on establishing a specific standard of what constitutes a material error, did note that relying on the common industry standard of \$0.01 a share or 0.5% of the NAV would not be unreasonable.

The SEC explained that the reporting is intended to supplement the board's oversight, not to replace it. The SEC acknowledged

that the changes made to the reporting requirements are designed to enhance flexibility of reporting to better match boards' needs and to minimize the chance that boards receive reporting that is too detailed or repetitive to facilitate appropriate oversight. This will be welcome news to boards and investment advisers as today 99% of the Deloitte Fair Valuation Pricing Survey⁴ participants prepare and receive summarized, often risk-based reporting. Given that the SEC seems to have given the industry the green light to continue to focus on risk-based reporting and rationalize the amount of information that boards receive, the time is now to focus on what information and key valuation indicators (KVIs) matter most when price uncertainty enters the market.

New and modified changes from SEC Proposal:

Establishment of rule 31a-4, moving recordkeeping requirements out of rule 2a-5

Removal of separate requirement for written policies and procedures from rule 2a-5, as deemed covered by rule 38a-1

Introduction of "valuation designee" terminology as opposed to "assign"

Modification of reporting requirements including content and frequency enabling more board judgment and tailoring. Specifically, changing the prompt notification requirement from 3 days to a max of 5 days with 20 days to make a determination of a material matter

Specific guidance on board oversight particularly around obligation towards conflicts of interest and regular engagement

Eighteen-month transition period (as opposed to a one-year transition period in the proposal) following the effective date of the final rule

Impacts on Key Industry Stakeholders

Impacts for investment advisers: Even if the final rule did not result in significant changes in valuation practices, there are certainly more formal risk assessment exercises, reporting and recordkeeping compliance requirements that will be felt by the investment adviser and key members of the investment adviser's team. Beyond the initial lift to understand and implement the rule, chief compliance officers and chief risk officers will undoubtedly be tested with ongoing monitoring and reporting responsibilities. It is not clear whether compliance with the rule could drive other changes as well; investment advisers may find a need to add more resources, upskill talent or enhance its valuation technology platforms. While the less prescriptive approach for board reporting adopted will provide more flexibility to investment advisers, we anticipate investment advisers will have to conduct proactive discussions with the board to appropriately set expectations. Ensuring that there are no expectation and communication gaps between the investment adviser and the board will be critical to ensuring success.

We believe that investment advisers should also focus on the impacts of rule 2a-5 and rule 31a-4 on their business in light of other recent SEC proposals and rules, including ETFs,⁵ liquidity risk management,⁶ derivatives,⁷ fund of funds,⁸ and shareholder reporting.⁹ By taking a holistic approach to planning and implementing these regulatory changes, investment advisers may not only ensure compliance, but can leverage technology to build a stronger and more efficient governance, operating, and compliance models.

Impacts for boards: At first glance, this rule may give many boards peace of mind with respect to their current practices as compared to the SEC established framework for the fund valuation process and board responsibilities, but there is still work to be done and judgements to be made. The final rule further defines the expectations of the board's role and stresses the SEC expectation that boards are active in fulfilling their oversight responsibilities.

Each board will need to continue to work with the investment adviser to re-evaluate valuation policies and procedures and look for ways to strengthen its oversight model in the context of the final rule. Specifically, the final rule is full of the action words that highlight a board's oversight responsibilities. These action words include:

| | |
|-------------|--------------|
| Designating | Assessing |
| Managing | Selecting |
| Applying | Overseeing |
| Evaluating | Testing |
| Identifying | Establishing |
| Monitoring | Approving |
| Maintaining | |

Boards will need to partner closely with the investment adviser to address these responsibilities. The SEC also made it clear that oversight should be active and not passive by including several open-ended statements that require board judgements on the amount of information, reporting and input they provide, respectively to each fund group's final framework. Examples of these open-ended action statements/judgments include:

- Any reports or materials requested by the board
- Board should follow up as necessary for its oversight
- Directors should ask questions and seek relevant information.

Working with the investment adviser to develop or refine these active oversight activities and a roadmap to compliance will be key to be as efficient as possible. The final specific content and format of the periodic or prompt reports and supplemental information under the final rule is left to the board and valuation designee and, therefore, there is work to do to make sure the board is clear and concise on their expectations of the valuation designee.

Impacts for auditors: For funds that use pricing services, the final rule requires that the board or the investment adviser establish a process to monitor and evaluate the pricing services. Moreover, the final rule emphasized the importance of adhering to the valuation principles in ASC Topic 820-*Fair Value Measurement* (ASC 820) when selecting a fair value methodology.¹⁰ These requirements may help to align management's or the board's responsibilities and expectations.

Rescinding Accounting Series Release (ASR) 118 eliminates the requirement for auditors to test the valuation of 100 percent of the fund's portfolio holdings. This means that auditors have the option to follow PCAOB guidance and potentially utilize sampling techniques in testing the valuation of the portfolio. The SEC specifically noted that boards or valuation designees could request that their auditor continue current practice to verify 100% of the values of the fund's investments if they determine that this approach is preferable. Further, technological advancements and efficiencies in vendor pricing may result in auditors continuing to test 100 percent of the fund's portfolio.

Synching up the final rule with current market practices

The designation model to the fund's investment adviser is something we've seen evolve over time through the lens of data and trends captured in the 18 editions of the Deloitte Fair Valuation Pricing Survey (the Surveys). With over 100 fund groups participating in the 18th edition, we continue to obtain valuable insights into emerging, maturing, and industry valuation practices.

In fact, the Surveys have evidenced that boards and fund groups already have some of the elements of the designation framework with respect to the role of the investment adviser in determining fair valuation, assessing and managing risks, and overseeing and evaluating pricing services.

However, gaps in practice exist across fund groups that will need to be addressed. The flexibility and judgment once afforded to the valuation policies and procedures now requires specific mapping back to rule 2a-5.

The final rule does mirror some of the emerging, maturing, and industry trends already in place today:

- Boards continue to play an important role in identifying and managing the fund's valuation risks.
- Some boards meet with the fund's chief risk officer or members of the risk committee on a periodic basis to discuss the valuation of the portfolio securities as part of the assessment and management of previously identified risks.
- Some boards noted that they identified conflicts of interest as a risk item in writing with a description of procedures to address it
- Many boards already periodically review the appropriateness and accuracy of the methodologies used in valuing securities and make any necessary adjustments.
- Some boards focus on mitigating potential conflicts of interest with the investment adviser and to a lesser extent, conflicts of interest of other parties.

Key Survey Observations

64 percent of boards assess and refine the format, content, and frequency of the reports generated from a valuation dashboard

28 percent of survey participants have determined today what a "material" valuation risk is

11 percent have put in writing the valuation risks for each asset class they manage

69 percent described the risks they have identified as "high-level risks" made up of five or fewer risks

Key Survey Observations

26 percent of survey participants noted that they identified conflicts of interest as a risk item in writing with a description of procedures to address them

51 percent of boards explicitly require that the one or more board members "must be involved" and/or "must be notified" in the resolution of certain valuation matters

35 percent of boards meet with the fund's chief risk officer or members of the risk committee on a periodic basis to discuss the valuation of the portfolio securities

63 percent of survey participants reported that their boards received price challenge information

35 percent have performed analysis, testing, or inquiries regarding how fourth parties are providing data used by third-party pricing sources

Looking ahead

The SEC tackled a difficult area that has not been modified significantly in more than 50 years with an objective of providing a more modern, consistent, and flexible framework around valuation for boards, investment advisers, auditors, and other key stakeholders. All stakeholders should recognize that these rules have emerged during a trying period for all but are intended to have a lasting impact.

Boards and investment advisers now have a fresh opportunity to identify valuation risks and consider how to manage them. In doing so, they can take what they have learned and reassess whether new procedures should be developed, or existing processes modified to improve their identification and response to similar challenges in the future.

We anticipate continued usage of dashboards to monitor KVIs as an important part of summary reporting. As the industry works to comply with the final rule, we can see the use of technology playing a larger role. The SEC noted in the final rule that *"We continue to believe that boards should request, and valuation designees should provide, such relevant trends dashboards and other analytical tools that the board believe it needs in order to perform appropriate oversight"*.

99 percent of Survey participants reported the use of summarized reporting or KVIs and 46 percent reporting the use of valuation risk dashboards

Lastly, it is noteworthy to mention a few immediate adoption concerns. First, as noted the SEC was not swayed by industry comments focused on the implications of including level 2 securities¹¹ within the scope of the final rule as being fair valued in good faith. This puts an additional obligation on the board reporting and the recordkeeping requirements. Also, since the definition of readily available market quotations as noted above will apply to all contexts under the 1940 Act including rule 17a-7, some securities may no longer fall under the rule 17a-7 trading exemption. The SEC did suggest that rule 17a-7 could be next on the modernization agenda.

Second, an immediate concern revolves around who can be designated as the valuation designee. The SEC went into great depth on its final consideration aligning this designation to the investment adviser and only making additional flexibility for funds that are internally managed. This seems to immediately put stress in investment series trusts whereby the investment adviser is solely managing the portfolio and is part of a "turn key" provider's solution that may include an established governance structure and process, fund accounting and administration, legal and compliance support, and the valuation function. Thus, these investment advisers may not be as integrally involved in the day-to-day valuation process. Along the same lines, the SEC clearly stated that a sub-adviser cannot be the valuation designee, which may have some investment advisers of sub-advised funds focused on managing the valuation process much more closely.

The final rule will be effective 60 days after publication in the *Federal Register*.¹² Once the final rule becomes effective, a fund may voluntarily comply with the rule as well as the associated new recordkeeping requirements in advance of the eighteen-month transition period.

Endnotes

1. The final rule does not require particular testing methods or a specific minimum frequency for the testing. Further, the SEC stated, *"We believe that funds that have even a limited amount of fair valued investments should test their methodologies, and therefore are not providing a de minimis exception."*
2. Rule 38a-1 under the 1940 Act provides that the policies and procedures must be reasonably designed to prevent violations of the federal securities laws (as defined in the rule), and rule 206(4)-7 under the Investment Advisers Act of 1940 (Advisers Act) provides that the policies and procedures must be reasonably designed to prevent violations of the Advisers Act and the rules thereunder.
3. Rule 2a-5 supersedes the following SEC guidance: ASRs 113 and 118; 2014 Money Market Fund Reform (specifically guidance on thinly traded securities and the use of pricing services); and other no-action letters and related staff guidance around fair value.
4. Since 2001, Deloitte has released 18 editions of the Fair Valuation Pricing Survey: <https://www2.deloitte.com/us/en/pages/financial-services/articles/annual-fair-valuation-survey.html>.
5. SEC, 17 CFR Parts 210, 232, 239, 270, and 274 [Release Nos. 33-10695; IC-33646; File No. S7-15-18] RIN 3235-AJ60, Exchange-Traded Funds, Final Rule summary, <https://www.sec.gov/rules/final/2019/33-10695.pdf>.
6. SEC, 17 CFR Part 274 [Release No. IC-33142; File No. S7-04-18] RIN 3235-AM30 Investment Company Liquidity Disclosure, Final Rule summary, <https://www.sec.gov/rules/final/2018/ic-33142.pdf>.
7. SEC, 17 CFR Parts 239, 249, 270 and 274 Release No. IC-34084; File No. S7-24-15 RIN: 3235-AL60 Use of Derivatives by Registered Investment Companies and Business Development Companies, Final Rule summary, <https://www.sec.gov/rules/final/2020/ic-34084.pdf>.
8. SEC, 17 CFR Parts 270 and 274 Release Nos. 33-10871; IC-34045; File No. S7-27-18 RIN: 3235-AM29 Fund of Funds Arrangements, Final Rule summary, <https://www.sec.gov/rules/final/2020/33-10871.pdf>.
9. SEC, 17 CFR Parts 200, 230, 239, 240, 270 and 274 Release Nos. 33-10814; 34-89478; IC-33963; File No. S7-09-20 RIN: 3235-AM52 Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, Proposed Rule summary, <https://www.sec.gov/rules/proposed/2020/33-10814.pdf>.
10. See ASC 820-10-35-24A through 25C.
11. ASC 820 defines level 2 inputs as *"Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly."*
12. SEC, 17 CFR Parts 210 and 270 Release No. IC-34128; File No. S7-07-20 RIN 3235-AM71 Good Faith Determinations of Fair Value, Final Rule Summary, <https://www.sec.gov/rules/final/2020/ic-34128.pdf>.

Authors

**Paul Kraft**

Partner
US Mutual Fund & Investment Adviser practice leader
Deloitte & Touche LLP
+1 617 437 2175 | pkraft@deloitte.com

**Katelyn Yorra**

Senior manager
Deloitte & Touche LLP
+1 617 585 5905 | kyorra@deloitte.com

**Ryan J. Moore**

Partner
Deloitte & Touche LLP
+1 703 251 1874 | ryanmoore@deloitte.com

Contributors

**Rajan Chari**

Partner
Deloitte & Touche LLP
+1 312 486 4845 | rchari@deloitte.com

**Bryan Morris**

Partner
Deloitte & Touche LLP
+1 703 885 6200 | bryanmorris@deloitte.com

**Maria Gattuso**

Advisory Principal
Deloitte & Touche LLP
+1 203 423 4445 | mgattuso@deloitte.com

**Tom Wines**

Senior manager
Deloitte & Touche LLP
+1 617 437 3088 | twines@deloitte.com

**Dan Rooney**

Partner
Deloitte & Touche LLP
+1 312 486 0971 | danrooney@deloitte.com

**Abdel Rahman Nimer**

Senior manager
Deloitte & Touche LLP
+1 714 436 7088 | animer@deloitte.com

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