

# SEC Proposes New Valuation Rule

April 28, 2020



On April 21, 2020 the [Securities and Exchange Commission issued proposed Rule 2a-5](#) under the Investment Company Act of 1940, raising the prospect of providing the first major guidance on valuation to fund boards since 1970.

Rule 2a-5 largely would codify existing practices that have developed alongside other major rulemaking, including Sarbanes-Oxley in 2002, the compliance rules of the Investment Company and Investment Advisers Acts in 2003 and FASB's codification of ASC Topic 820 in 2006 and 2009. While not departing significantly from existing approaches to valuation, the proposed rule would require a significant effort on the part of funds in determining necessary changes to existing roles, responsibilities, policies and reporting.

The proposed rule leverages GAAP and the compliance rules in its implementation, borrowing, for example, the categories for valuation methodologies from ASC 820 (market approach, income approach and cost approach) and requiring that funds' 38a-1 compliance programs capture certain of its requirements.

While fund boards are currently responsible for the good faith determination of the fair value of securities, Rule 2a-5 acknowledges the degree to which many boards rely on investment advisers in reaching such determinations,

allowing boards to formally “assign” certain responsibilities to the adviser.

Regardless of such assignments of responsibility, the proposed rule requires boards to continue to assess and manage material risks, including possible conflicts of interest within the adviser’s valuation process, the use of and source of unobservable inputs into valuations and risks introduced by service providers, to name a few.

The proposed rule requires that boards or advisers select, apply and test fair value methodologies, and also formalizes the oversight and evaluation of pricing services. Testing methods would need to be determined and frequency of testing identified, with results and other related information forming the basis for quarterly reports to the board.

The role of the administrator/fund accountant in the pricing process does not appear to receive much attention in the proposed rule, though we expect it may be explored further during the comment process. Fund administrators have implemented significant automation to handle daily pricing in the face of greatly increased volume and complexity of investments held in the funds they service. Administrators also often provide very robust due diligence oversight of the pricing vendors they hire prior to passing along valuations to their clients, and hopefully boards and advisers will be able to leverage this work in meeting their oversight obligations under any final rule.

If passed, Foreside’s fund CCOs will be tasked with updating compliance programs and/or their due diligence reviews of adviser programs, depending upon the degree to which the board assigns responsibilities to the adviser. Assuming the assignment of responsibilities, adviser policies must specify the titles of the persons responsible for determining fair value, and reasonably segregate the process of making fair value determinations from the portfolio management of the fund. Funds may wish to take the opportunity to review the staffing and structure of existing committees with similar mandates, such as valuation committees and those persons fulfilling the duties of the Liquidity Risk Management Program Administrator, in order to determine whether opportunities exist to harmonize committee responsibilities, procedures or charters with any new obligations.

The current timeline for the effective date of any final rule is one year following its publication in the Federal Register. Considering that the comment period ends July 21, 2020, this implies that funds would have until at least Q4 2021 to prepare.

Foreside’s teams of Treasurers and Fund Chief Compliance Officers participate in numerous valuation committee and board-level discussions relating to a wide variety of product and investment types, allowing us to develop a keen sense of best practice with respect to valuation policies and operational considerations. As the regulatory demand on funds continues to grow, we hope to be part of your solution. For further information on this Rule or if you would like to speak with one of our experts, please reach out to Foreside at [busdev@foreside.com](mailto:busdev@foreside.com).

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