Indus Valley Partners

IVP PRICE MASTER - WHITE PAPER

The Evolution of **Valuation**

SEC Rule 2a-5: Determining Fair Value in Good Faith

Table of Contents

Executive Summary

On **December 3rd, 2020**, the SEC proposed **rule 2a-5** under the Investment Company Act of 1940. The rule establishes new requirements and responsibilities asset managers must meet in order to determine fair value of assets in good faith.

The rule goes into effect on **March 8, 2021**, or **60 days** after the publication in the federal register. This date marks the beginning of an **18-month** period for alignment and compliance, which means asset managers have until **September 22, 2022** in order to comply.[1]

The biggest change the rule stipulates is the creation of a "Valuation Designee" responsible for overseeing and calibrating fair value determination as well as regularly reporting any material changes to fair value determination processes (and bias involved) to the board.

Together, the board of directors and the Valuation Designee must actively oversee, at large, the following items:

- Periodic assessment and management of valuation risks
- Establishment and application of fair value methodologies
- Testing of fair value methodologies for appropriateness and accuracy
- Oversight and evaluation of pricing services
- Board reporting
- Recordkeeping

The Valuation Designee must have fiduciary duties towards the fund, and so this person may be the fund adviser or a trustee/depositor (for UITs only). The designee must not be a portfolio manager, as this person may not determine or exert influence on the fair values ascribed to the portfolio.

In addition, Rule 2a-5 expands the definition of which quotes can be considered "readily available market quotations," borrowing from the fair value hierarchy outlined in the US GAAP (i.e. a level 1, level 2, level 3 input system).

Finally, the rule references rule 31a-4 and restates its recordkeeping requirements and also rescinds ASR 113 and ASR 118 as of the effective date of rule 2a-5, because their guidance is superseded or made redundant by the new rule.

Rule 2a-5 applies to all registered investment companies under the 1940 Act as well as business development companies and unit investment trusts (UITs) whose initial date of deposit (or rollover) falls on or after the effective date of the rule.

What Does the Rule Do?

SEC Rule 2a-5 outlines a number of new responsibilities for asset managers.

Rule Content	Implication
Establishes a principles-based framework for creating fair valuation processes	The board and Valuation Designee must refer to the rule's guidelines and framework to establish a fair valuation process
Identifies functions that must be performed to determine fair value in good faith	The board and Valuation Designee must follow the functions outlined in the rule
Provides a non-exhaustive list of sources of valuation risk	The board and Valuation Designee can refer to the list to identify valuation risks that are relevant to each portfolio
Allows the board to choose a fair valuation method for new investments after purchase but before NAV calculation	The board and Valuation Designee must assign a fair value determination method to a newly purchased asset/investment type before its valuation. However, the fund can decide which method to use after the purchase.
Allows funds to select a new fair value methodology if it is more accurate. Any change must align with a change in circumstances and must be documented.	The rule clarifies that if circumstances change and a different fair value method (compliant with ASC 820 principles) is more or equally representative of the fair value for the investment, the method can be changed. This change must be reported to the board and sufficiently documented in recordkeeping as well as in annual and quarterly reports and prompt notifications.
Supersedes the last paragraph on valuing thinly traded securities in the 2014 Money Market Funds Adopting Release.[2]	The new rule supersedes the paragraph regarding board oversight of certain pricing services and methodologies of NAV calculation.
Allows UITs to appoint the fund's depositor or trustee to perform fair value determinations.	Because UITs do not have a board of directors, the fund's depositor or trustee is allowed to be made responsible for fair value determination.
Defines "board" as the full board of directors or a designated committee (Valuation Committee) composed of a majority of directors.	The rule clarifies that "board" can be the full board of directors or a valuation committee composed of a majority of directors who are not interested persons of the fund.
Allows funds to receive third-party services for back-testing and performing calculations required by the valuation method. The board and Valuation Designee remain liable for any errors.	The board and Valuation Designee can rely on third parties to perform actions or tasks required by the valuation process. It clarifies, however, that the board and Valuation Designee are liable for any errors resulting from using these providers.
Asks the board to periodically review the financial resources, technology, staff and expertise of the Valuation Designee and any service providers used for valuation.	The board is expected to ensure that the resources assigned to the fair valuation process are competent and have the necessary expertise and bandwidth to perform their duties.

What Does the Rule Do?

SEC Rule 2a-5 outlines a number of new responsibilities for asset managers.

Rule Content	Implication
Introduces the concept and workflow of "prompt notification" in case of material matters related to fair valuation.	The rule requires the Valuation Designee to notify the board within five days of identifying a material matter. If the Valuation Designee is unable to determine the materiality of the matter, the board must be notified within 20 days of the notification. Five more days are allowed for determining any actions resulting from the same.
Requires the investment adviser to maintain records if elected as Valuation Designee.	If the fund's adviser is the Valuation Designee, they must maintain all records as mentioned in rule 31a-4. This applies even in cases where the performance of any documented items is outsourced to a third party.
Clarifies that quotes are considered "readily available" only when the quoted price is unadjusted and is available in active markets for identical investments that the fund can access at the measurement date, provided the quote is reliable.	The rule clarifies the definition of a "readily available" quote. This complies with the FASB levels. Only a Level 1 input is considered readily available. Any quotes with Level 2 or Level 3 inputs must be considered fair valued.

What Does the Rule Not Do?

Much of what the new rule requires are broad guidance that does not contain explicit instructions. In other words, asset managers must determine how best to comply with the guidance independently. The following are examples of specific instructions not contained in the new rule.

Rule Content	Implication
It does not establish a single approach for making fair value determinations.	The board and Valuation Designee must identify an approach to fair value determination tailored to specific investments and types.
It does not identify specific valuation risks for periodic assessment.	The board and Valuation Designee must identify valuation risks to monitor and assess periodically based on the fund's investments or investment types.
It does not establish a specific re-assessment frequency.	The board and Valuation Designee must establish a frequency for re-assessment of material matters and valuation risks. The minimum frequency is annually.

Rule Content	Implication
It does not require the Valuation Designee or the board to specify the fair value methodology for new types of investments until the valuation is done after purchase.	The board and Valuation Designee must assign a fair value determination to a new asset/investment type before the valuation of the new asset/investment. However, this clause gives funds the option to make the decision after the purchase is complete.
It does not ask the board or Valuation Designee to identify in advance all of the circumstances that might require a fair value determination.	The board and Valuation Designee are not expected to identify, in advance, an exhaustive list of circumstances that may require the fair valuation of a security. If a new circumstance is identified, the fund is permitted to make an addition to the existing list.
It does not ask for a list of criteria for determining when market quotations may no longer be reliable.	In a separate section, the rule explicitly provides the circumstances for which a quote is considered “readily available.” If a quote is no longer reliable, the reason may be documented. It need not come from a predetermined list of reliability criteria.
It does not specify a method or frequency for testing the fair value determination method.	The rule only states that testing is mandatory and must be carried out, at minimum, on an annual basis. Funds holding fewer fair valued instruments are not exempt from this requirement.
It does not list criteria for what constitutes a pricing service.	The rule clarifies that it considers “pricing services” to be third parties that regularly provide funds with information on evaluated prices, matrix prices, price opinions or similar price estimates or information to assist in determining the fair value of an instrument.
It does not provide criteria for evaluating pricing services.	While the rule does not set forth criteria for making these evaluations, it does require asset managers to establish a regular process for the approval, evaluation, and monitoring of pricing services.
It does not exempt internally managed funds from selecting a Valuation Designee due to the absence of an adviser.	In the case of an internally managed fund, the Valuation Designee may be an officer of the fund because they are considered to have fiduciary duties.
It does not assume passive oversight by the board. The board is expected to ask questions and probe the quarterly/annual reports and prompt notifications.	The rule urges the board to probe the reports made available to them and request further information if required.
It does not require a specific set of analyses to be used in quarterly meetings.	The board and Valuation Designee must identify relevant analyses and metrics to include in quarterly meetings. These may include metrics such as stale prices in the previous quarter. The quarterly report must, however, have a list of investments and investment types assigned to the Valuation Designee for fair valuation and a list of any material matters identified in the previous quarter.

Rule Content	Implication
It does not establish a NAV percentage or threshold that qualifies for prompt notification.	The board and Valuation Designee must assign a fair value determination to a new asset/investment type before the valuIf an investment contributing to 0.01% of NAV is moved, for example, prompt notification is still required. This is not stated explicitly by the final rule. The rule does, however, mention that standard rules may be used to trigger a prompt notification. The board or Valuation Designee are expected to identify these rules, if required.of the new asset/investment. However, this clause gives funds the option to make the decision after the purchase is complete.
It does not prohibit portfolio managers from participating by providing insights and inputs, but the portfolio manager must not determine or exert substantial influence on the fair values ultimately ascribed to these investments.	The rule limits the portfolio manager's participation to providing insight into the investments and investment types. The portfolio manager must not be involved in the active determination of the fair valuation method or its execution.

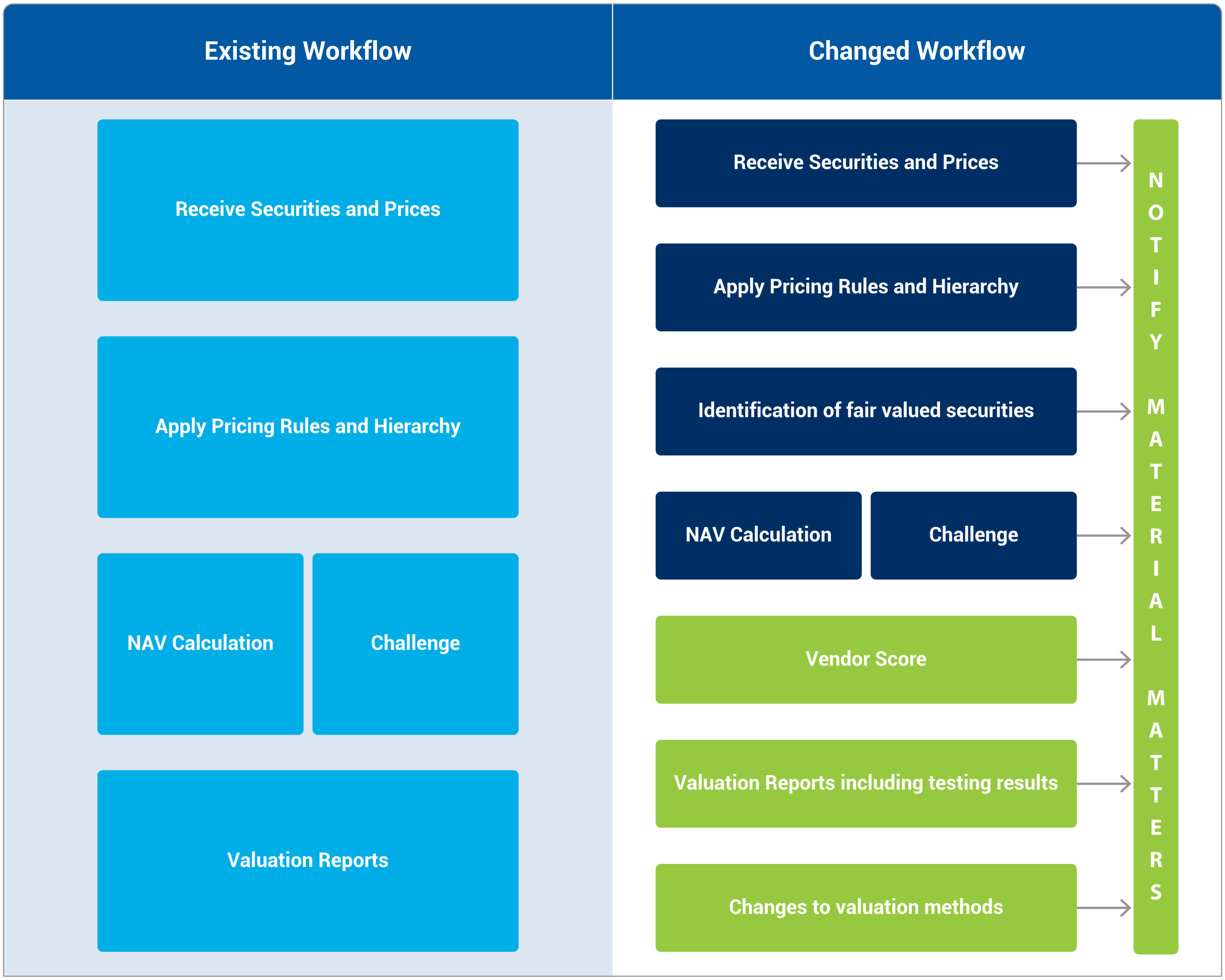
Compliance Requirements

Asset managers have a number of new responsibilities outlined in SEC Rule 2a-5. Here is summary of those new requirements for compliance.

- Name a Valuation Designee
- Establish valuation risks to assess and frequency of assessment
- Identify investments and investment types that require fair value determination and for which the Valuation Designee is responsible
- Specify key inputs and assumptions for fair value determination by asset class or portfolio holding
- Select a fair value determination methodology in conjunction with ASC Topic 820 principles
- Select a frequency for review of the appropriateness and accuracy of selected methodologies
- Select a frequency and method for testing the fair value methodology (such as back testing or calibration)
- Establish a process to approve, monitor, and evaluate pricing service providers
- Establish a process for initiating price challenges with guidelines instead of objective thresholds
- Choose, along with the Valuation Designee, all the members and titles of those involved in the fair valuation process, including those with the authority to override prices
- Differentiate portfolio management from the fair value ascribed to the investments
- Plan recordkeeping according to requirements stated in rule 31a-4 and rule 2a-5
- Establish documentation requirements based on US GAAP Levels (e.g. Level 3 inputs require more extensive documentation)
- Establish a periodic quarterly report system that contains documents requested by the board and a summary of material matters
- Identify the analyses and metrics required to be presented as part of the quarterly reports
- Establish an annual report system that contains a summary of testing performed and an analysis of the adequacy of resources allocated to the fair valuation process
- Establish a prompt notification system and workflow

Visualizing the Process

Understanding the implications of rule 2a-5 can be easier when visualizing how the new fair value determination process differs from the previous one.



This diagram makes it clear that the new process includes: additional layers of pricing services approval and monitoring, valuation reports (including testing reports), and the option to fine tune valuation methods based on the results of testing.

There is also a new parallel process, that of notification for material matters or risks. At every stage of the valuation process, any material risks or changes must be conveyed to the board through a prompt notification or a quarterly or annual report as applicable.

On the whole, rule 2a-5 demands a higher degree of involvement and responsibility from the board with respect to valuation practices. It does so by establishing multiple requirements that involve the board directly, including reporting, approval processes, mandatory testing, and notification.

The rule, however, allows the board to tailor these processes to fit the portfolio and relevant investment types.

Streamlining Compliance with Automation

Automation technology gives asset managers a ready-made approach for achieving compliance with SEC Rule 2a-5. These solutions have established processes for managing pricing data, reports, and related workflows that are relevant to the new rule.

IVP, for examples, offers software and consulting that can help asset managers ease into compliance with Rule 2a-5 over the next 18 months.

IVP Price Master includes all of the following functionality:

> Challenge process workflow and suggestion process implementation

> Determination and monitoring of securities considered "fair valued" based on inputs such as FAS levels, vendors, and pricing fields (e.g., if the JPM PD Evaluated Price is used then Fair Value, if Close Price is used then Readily Available)

> Identification of key inputs to NAV via reports/post action to NAV calculation systems

> Preservation of initial due diligence of pricing vendors: valuation methodologies, testing frequency, reliability

> Provision of workflow to approve, monitor, and evaluate pricing service providers

> Preservation of data points required for back testing or calibration

> Automatic customizable quarterly reporting (e.g. stale/static prices, challenged prices, material changes in NAV/pricing)

> Automated customizable annual reporting (e.g. summary of testing results)

> Prompt notification of material changes (based on threshold breaches) and workflow monitoring (e.g. immediate notification, escalation if no action within five days, escalation if no action within 20 days)

> Audit of material changes such as hierarchy changes, rule changes, vendor changes

In addition, IVP offers consulting services informed by decades of assisting asset managers with pricing workflows. With respect to the new rule, a consulting engagement could accelerate compliance efforts by assisting with all of the following:

> Suggestions for the Valuation Designee based on guidelines

> Determination of resources involved in fair value determination and valuation

> Analysis of securities and security types that require fair valuation

> Analysis of readily available quotes and pricing services

> Analysis of valuation risks by security type and optimum frequency of assessment

> Selection and review of appropriate fair value methodologies by security/investment type and compliance with ASC Topic 820

> Selection of appropriate testing methodologies and optimum frequency

> Provision or review of tools for back testing valuation methodologies

> Selection of analytics required for quarterly reports and provision or review of dashboard tools (e.g. investments that qualify for fair value, stale prices, etc.)

> Provision or enhancement of tools for producing annual reports (e.g. summary of testing results, resources assigned to fair value determination and valuation, etc.)

> Determination of records to maintain by investment class, asset class, or investment, depending on relevant recordkeeping standards

Conclusion

Asset managers will need to work efficiently and act decisively to establish new workflows that comply with SEC Rule 2a-5. The list of new responsibilities is long and the nature of the rule as a framework rather than explicit requirements means that firms will need to first engage in a process of understanding how the rule affects their specific portfolios and processes. Working with a partner that understands the framework and can provide ready-made solutions for related requirements offers a way to expedite this work.

Glossary

Material Matters
Matters associated with the Valuation Designee's process that materially affect fair value of the designated portfolio of investments.

Examples:

- An assessment of a significant deficiency or material weakness in design or effectiveness of the Valuation Designee's fair value determination process, or of material errors in the calculation of net asset value.
- NAV calculated with mid-price when valuation process specifies to calculation with bid price[3]

Interested Persons of the Fund

A fund director may be treated as "interested" if they hold—or have held at any time since the beginning of the last two completed fiscal years of the fund (the "two-year period")—certain positions with a specified entity. A position that a director holds with a specified entity would be considered a "material business or professional relationship" if it would tend to impair a director's independence by providing incentives for the director to place their own interests over the interests of shareholders. The key factors in evaluating whether a director's position with a specified entity would tend to impair their independence include the level of the director's responsibility in the position and the level of compensation or other benefits the director receives from the position.

Examples:

- An individual who served as the fund's portfolio manager during the two-year period would have had a material business or professional relationship with the fund and its investment adviser.[4]

Valuation Risk

Valuation risk includes:

- Potential market or sector shocks or dislocations and other types of disruptions that may affect the Valuation Designee's (or third party's) ability to operate
- The extent to which a fair value methodology uses unobservable inputs, particularly if these inputs are provided by the Valuation Designee3
- Types of investments held (or intended to be held) by the fund and the characteristics of those investments

References

1. Sutherl, E., Hildebr, L.-S. M., Davison, T. W., DuCharme, J. C., Waters, J. M., Beyea, C. R., ... Oberndorf, A. G. (2021, December 1). SEC modernizes valuation practices | Lexology. Retrieved February 2, 2021, from https://www.lexology.com/library/detail.aspx?g=fb8e0e10-b0f1-4633-ad5e-d10637c6e040
2. Securities and Exchange Commission. (2014). Money Market Fund Reform; Amendments to Form PF, pp 283-288.
3. Securities and Exchange Commission. (2021). Securities and Exchange Commission—17 CFR Part 210 and 270. Securities and Exchange Commission.
4. Securities and Exchange Commission. (1999, October 20). SEC Interpretation: Independent Directors of Investment Companies. Retrieved February 2, 2021, from https://www.sec.gov/rules/interp/ic-24083.htm