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50 Years In the Making

SEC Finalizes Long-Awaited Valuation Rule

By David Isenberg December 4, 2020

The Securities and Exchange Commission on Thursday unanimously voted to adopt a rule that allows directors to delegate the task of assigning fair values to funds.

The new Rule 2a-5 will permit boards to designate advisors, fund officers or other parties to make fair valuation determinations, the rule states. That party would be the “valuation designee.” The board can also choose to handle the duty itself. However, if they decide to hand off the task, the board is responsible for oversight and reporting.

Whoever assigns the fair value must periodically assess and manage risks. They’re also responsible for selecting, applying and testing methodologies. And they must also oversee and evaluate any pricing services they use.

“Main Street investors increasingly access our capital markets through funds and rely on them to value their investments properly,” said SEC chairman Jay Clayton in a press release. “Today’s rule is designed to improve funds’ valuation practices, including by providing for effective board oversight, for the benefit and protection of fund investors.”

Commissioner Hester Peirce referred to the fair value rulemaking process as “difficult” and “long overdue.”

The valuation process has not been comprehensively addressed for 50 years, the SEC said Thursday.

The 210-page rule also clarified that a valuation must be assigned to a portfolio security when its market quote is “readily available.” This must happen when the security has a quoted price in an active market and the security is accessible and reliable.

The SEC also adopted a separate rule that outlines the recordkeeping requirements associated with valuation. Rule 31a-4 will impose documentation requirements for valuation and the valuation designee.

Separating the recordkeeping obligations centralizes all investment company recordkeeping requirements and removes what would have been a possibility that a recordkeeping violation would have automatically been a violation of the valuation rules, Peirce said.

After the rule was proposed in April, the Investment Company Institute had argued that the draft version piled too many recordkeeping duties onto advisors’ plates.

The final version of the rule also removed certain detailed reporting requirements and replaced them with a more “principles-based” framework.

Excluding a safe harbor “should not be read to mean that the purpose of this rule is to trip people up on technicalities,” Peirce said. “This possibility of fund boards’ being charged with violating Rule 2a-5 for transgressions that do not affect the actual valuation of fund assets fuels my opposition to the final rule’s unnecessary level of prescription.”

Despite Peirce’s objections, the rule still passed with all the commissioners’ support. “That’s a sign that everybody seemed to be happy, that it provided enough protections to shareholders and at the same time modernized it enough to take it forward,” said Vadim Avdeychik, of counsel at Paul Hastings. Many of the most recent initiatives passed by a 3–2 vote.

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The ICI and the Independent Director’s Council applauded the final rule in a statement because it shows that the SEC acknowledges the daily practicalities of valuation and the role of accounting standards in the process, they said.

“The final rule recognizes the complementary roles that fund boards and advisors play in the fair valuation process and the discretion they exercise,” ICI general counsel Susan Olson said in the statement.

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The SEC anticipates that 71.25% of mutual funds will be impacted by the fair value rule. However, the SEC noted that the number may be understated, and Ethan Corey, a partner at Practus, believes that figure is low.

“Because a fund never knows in advance when a market quotation may be deemed to be not reliable, all funds will need to have in place fair value procedures of one form or another,” Corey says.

The SEC made other several changes from the proposal in response to industry critiques.

For instance, the final version permits fund officers to assign the valuation if a fund is internally managed. That was not allowed under the draft version.

The final rule also removed a provision that would have required funds to assign values to investments before they actually own them.

It also loosens the proposal’s requirement that price challenges may only occur under specific circumstances. Under the final version, the fund must merely create a process for any such challenges.

In addition, the final version extends the amount of time that valuation designees have to report material matters back to the board. The proposal said that such information must be shared within three days, and the final version settled on five. The final version also eliminated a proposed mandatory quarterly assessments of the valuation process. Instead, valuation designees must answer board-submitted questions and information requests quarterly.

The rule will become effective 60 days after it's published in the Federal Register. Boards will have to comply 18 months later.

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