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Summary on SEC's Final Rule

Determining fair value and its impact on fund valuation reporting

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The US Securities and Exchange Commission ("SEC") has adopted new rules (2a-5 and 31a-4) under the Investment Company Act of 1940 (1940 Act) on 3 December 2020 with an effective date of 8 March 2021. The final rules have a compliance date of 8 September 2022 and would work to serve common fund valuation framework across all fund groups. While we believe that the final rule aligns with market practices in different industries today, it is under our consideration that many funds and companies would find it challenging shifting towards the rule. This paper will further breakdown and analyse the 212-page release by SEC and its impact on fund valuation reporting.

Key Takeaways from the Release

SEC's final rule provides requirements for determining fair value in good faith with respect to a fund for purposes of section 2(a)(41) of the Act and rule 2a-4 thereunder. The following are required to determine the fair value of fund investments in good faith:

- Assessing and managing material risks associated with fair value determinations
- Selecting, applying, and testing fair value methodologies
- Overseeing and evaluating any pricing services used

To achieve the above, SEC has set out specific requirements with respect to the 1940 Act:

01. Periodically Assess and Manage Valuation Risks: this requires the periodical assessment for any material risks associated with the determination of the fair value of the fund's investments, including material conflicts of interest, and to manage those identified valuation risks.

02. Establish and Apply Fair Value Methodologies: this requires that a board or valuation designee must:

- Select and apply appropriate fair value methodologies
- Periodically review the appropriateness and accuracy of the methodologies selected and make any necessary changes or adjustments thereto
- Monitor for circumstances that may necessitate the use of fair value

03. Test Fair Value Methodologies for Appropriateness and Accuracy: this requires that the board or valuation designee, as applicable, to identify the testing methods to be used and the minimum frequency with which such testing methods are used, but will not require particular testing methods or a specific minimum frequency for the testing.

04. Establishment of approving, monitoring, and evaluating process for each pricing service provider: this rule requires that the board or valuation designee, as applicable, establish a process for initiating price challenges as appropriate.

05. Adoption and implementation of written policies and procedures for fair value determination

Based on rule 2a-5(b), the final rule permit boards to designate the to the fund's adviser to perform fair value determinations or, if the fund is internally managed, an officer of the fund. However, SEC believes this should not be a passive activity and boards should maintain their oversight of the fair value determinations with a sceptical and objective view that takes account of the fund's particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determination process, and the skill and resources devoted to it.

Under 2a-5, the valuation designee is required both periodic and prompt notification and reporting.

Under periodic reporting, the final rule requires the valuation designee to make both annual and quarterly written reports to the board.

The quarterly reports must include:

- Any reports or materials requested by the board related to the fair value of designated investments or the valuation designee's process for fair valuing fund investments
- A summary or description of material fair value matters that occurred in the prior quarter:
- Any material changes in the assessment and management of valuation risks, including any material changes in conflicts of interest of the valuation designee (and any other service provider)
- Any material changes to, or material deviations from, the fair value methodologies
- Any material changes to the valuation designee's process for selecting and overseeing pricing services, as well as any material events related to the valuation designee's oversight of pricing services

The annual reports must include an assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of the designated portfolio of investments. This must cover:

- A summary of the results of the testing of fair value methodologies required under the final rule
- An assessment of the adequacy of resources allocated to the process for determining the fair value of designated investments, including any material changes to the roles or functions of the persons responsible for determining fair value

If the valuation designee becomes aware of matters that would materially affect the fair value of the designated portfolio of investments (defined as "material matters"). The board should be promptly notified regarding the matter (no event later than five business days after the valuation designee becomes aware of the material matter). Material matters would include:

- A significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process
- Material errors in the calculation of net asset value
- The valuation designee is also required by the rule to provide timely follow-on reports to the board, if determined appropriate.

Modifications from SEC

01 New terminology of "valuation designee" is introduced and used instead of "assign"

02 Adoption of new rule 31a-4 that applies to both registered investment companies and business development companies to contain the recordkeeping requirements associated with the final rule

03 Rule 38a-1 which covers written policies and procedures from rule 2a-5

04 Implementation and Transition Period (18-month transition period after effective date of the final rule)

05 New reporting requirements with content and frequency which allows more board judgment

06 Updating the prompt notification requirement to a maximum of 5 days (20 days to make a determination of a material matter)

07 Guidance on board oversight

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KPMG Ireland works to provide industry-leading professional services across various markets with our experienced expertise, valuation models and platforms. Facing the changing environment and complicated market regulations, we are keen to help our clients perform more efficiently and effectively for challenges ahead.

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