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Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Rule 2a-5; Good Faith Determination of Fair Value (SR-07-20)

Dear Secretary Countryman:

The international law firm of Sullivan & Worcester LLP ("Sullivan") respectfully submits the following comments to the Securities and Exchange Commission (the "Commission") in response to the Commission's proposed Rule 2a-5 - Fair value determination and readily available market quotations (the "Proposed Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"), and included in the Commission's proposing release "Good Faith Determination of Fair Value (the "Proposing Release").[1] For over sixty years, Sullivan has represented both large and small investment company complexes and business development companies ("Funds"), their boards of directors and independent directors ("Boards") and their investment advisers with respect to regulatory matters under the 1940 Act and other federal securities laws.

We applaud the Commission's efforts in developing the Proposed Rule. The Proposed Rule addresses many of the concerns raised over the years by both Funds and Boards with respect to the proper division of duties and responsibilities between Boards and Fund management in connection with the determination of the fair value of securities for which market quotations are not readily available. In doing so, the Proposed Rule appropriately identifies the areas of expertise and resources between these two parties and properly allocates duties and responsibilities in a manner that allows each party to utilize their respective talents and expertise, and to take advantage of the resources available to them, in a manner that is most appropriate and that will inure to the benefit of shareholders.

While the Proposed Rule would be a strong and welcome clarification of duties and responsibilities of Boards in the area of fair valuation, there are a number of areas that we believe require further consideration and clarification, especially from the perspective of small or single fund complexes. We discuss these matters below.

[1] *See* "Good Faith Determination of Fair Value," Investment Company Act Release no. 33845, 85 Fed. Reg. 28734 (April 21, 2020), available at www.sec.gov/rules/proposed2020/IC-33845.pdf

For purposes of this discussion, we assume that a Fund Board will determine to avail itself of the Proposed Rule's latitude in assigning the fair value function to the investment adviser to the maximum extent permitted by the Proposed Rule. We believe this will be the overwhelming position taken by Fund Boards if the Proposed Rule is adopted.

A. The Fair Value Process - The Proposed Rule requires that the fair value process include a periodic assessment of material risks associated with the determination of the fair value of a Fund's portfolio investments, including material conflicts of interest, as well as a discussion of how those identified risks are managed. The Proposed Rule permits a Board to assign this function to the investment adviser subject to the investment adviser providing the Board at least quarterly with a periodic written report which includes a summary or description of the material fair value risks, including any material conflicts of interest of the investment adviser or any service provider, and a summary or description of how these risks are managed.

1. Fair value risks and conflicts, particularly those described in the Proposed Release, are unlikely to change as frequently as the quarterly Board reporting mechanism seems to anticipate. While the Proposing Release indicates that the Commission believes the cost of producing such a report to be immaterial, it does not address the burden of producing that report. We believe that the burdens associated with the production of such a report on a quarterly basis are not immaterial, particularly for smaller advisers with limited resources. It seems unnecessarily burdensome to require a summary of these conflicts and risks to be repeated every quarter to the Board if they remain unchanged. In addition, the requirement would impose a material burden on the Board in reviewing this report, again with little to no benefit if material risks and conflicts remain unchanged. We believe that the Commission's recent efforts to reduce unnecessary burdens on Boards[2] where appropriate and subject to certain conditions so as to facilitate the Board's ability to focus its time and efforts more appropriately, should extend to this area as well.

   It appears to us to be more appropriate to require an annual report to the Board which would identify all material conflicts and material risks, and the means by which they are managed, as well as a quarterly reporting of any material changes to material conflicts and material risks. We note that an annual reporting requirement relating to material fair valuation risks would also be consistent with board reporting required of the Fund's chief compliance officer pursuant to Rule 38a-1(a)(4)(iii). As noted in the Proposing Release, Rule 38a-1 is intended to complement the Proposed Rule. We also note that such a requirement would mirror the provisions of Rule 22e-4, which requires the liquidity risk manager to provide an annual report to the Board on the operation of the liquidity risk management program.

2. The Proposed Rule does not indicate how often fair value risks will need to be re-assessed by the investment adviser. Left undefined, the current provision may very well be used by litigants to second-guess pricing decisions with the benefit of hind-sight.

[2] *See, e.g.*, Independent Directors Council, SEC Staff No-Action letter (Oct.12, 2018), (relief relating to Board approval of certain transactions under sections 10(f), 17(a) and 17 (e) and Rules 10f-3, 17a-7 and 17e-1 of the Investment Company Act).

The Commission should require annual re-assessment of all material conflicts and material risks as discussed above, unless the investment adviser becomes aware of any significant new material fair value risks, such as a decision to invest in a new type of instrument that may raise fair value issues, a loss of pricing coverage of a particular type of instrument by third party service providers or the potential for an unscheduled market close due to exigent circumstances, such as we have recently seen in connection with the COVD -19 pandemic and certain emerging market exchanges.

B. *Fair Value Methodologies* - The Proposed Rule requires that the investment adviser select and apply, in a consistent manner across asset classes, appropriate methodologies for determining fair value, including specifying (i) key inputs and assumptions specific to each asset class or portfolio holding (which must include the specific quantitative and qualitative factors to be considered as well as a description as to how the calculation is to be performed, which may include the formula used in the model), and (ii) which methodologies apply to new types of Fund investments. The investment adviser is permitted to change the asset class methodology for a particular investment provided that the Board is notified of this change and generates a sufficient record to support the deviation from the pre-selected methodology. The Proposing Release states that the Commission expects the consistent application of fair value methodologies across asset classes.

1. By requiring that methodologies must generally be applied consistently across asset classes, the Proposed Rule appears to contemplate that generally only one methodology may be used per asset class. The Proposed Rule permits the use of a methodology which is different from the methodology identified for the asset class for a particular security only after imposing a hurdle in terms of Board notification and documentation and record-keeping necessary to justify what it terms as a "change of methodology". This requirement is too restrictive and in fact counterproductive to the purposes of the Proposed Rule.

   First, the Proposing Release does not define what constitutes an asset class. The Commission should clarify that for fair valuation purposes, the investment adviser may differentiate asset classes into sub-classes and that different methodologies may apply to different sub-classes. Second, some asset classes or sub-classes may have a number of different methodologies that may be appropriate under different circumstances and for different securities within the broader asset class or sub-class. For example, frequently used methodologies in the fixed-income area include last sale, broker quotes, means or averages between bid-asked spreads, and interest rate driven models. Different methodologies might be appropriate in different circumstances. The Commission should allow the investment adviser to establish a number of different methodologies that may be used within a broad asset class or sub-class (as so defined by the investment adviser) and the investment adviser should be allowed to use whichever methodology it deems most appropriate—on a security by security basis, with appropriate documentation as to the rationale for each decision.

   The appropriateness of these decisions will be subject to the back-testing and Board oversight requirements set forth in the Proposed Rule. It is therefore unnecessary to

limit the investment adviser's discretion in this area. As currently drafted, the Proposed Rule could inhibit the investment adviser from employing a methodology which it believes most appropriate to fair value the security in question. For example, as discussed in B.2, below, the detailed record requirements associated with the selection of a "new" methodology are significant and the investment adviser is unlikely to be able to perform that task in the short window of time between the close of the market and the striking of a Fund NAV. This difficulty is avoided if a number of methodologies are pre-approved in advance, with the documentation requirement at the time of the use of a particular methodology limited to the question of why the selected methodology is most appropriate in the particular circumstance.

2. It is unclear what is achieved by requiring delineation (presumably in the investment adviser's valuation policies and procedures) of methodology "key inputs and assumptions specific to each asset class or portfolio holding", "specific quantitative and qualitative factors to be considered as well as a description as to how the calculation is to be performed" (collectively, "Methodology Inputs"). In selecting a methodology, the investment adviser necessarily will be focusing on all such matters and should retain records of its deliberations and basis for selecting a methodology. However, inputs and factors may differ by security within broad or even more narrow asset classes. Including this information in policies and procedures would appear to be burdensome, would make the policies and procedures cumbersome to use, and would be repetitive of the work already done by the investment adviser in analyzing and selecting the methodology in question. We do not see what purpose is advanced by requiring the additional burden of repeating these matters in the policies and procedures, nor do we see any value in requiring description of the mechanics of the calculations of formulas. Once again, the manpower burden that these requirements place on smaller advisers is not insignificant. The back-testing and Board reporting requirements contained in the Proposed Rule seem to provide a sufficient mechanism by which to assess the appropriateness of the methodology selected.

   As discussed in E. below, the proposed Methodology Inputs will be contained in the investment adviser's policies and procedures and these policies and procedures are proposed to be subject to Board oversight under Rule 38a-1. We believe that it is inappropriate to expect the Board to oversee the selection of Methodology Inputs. The Board does not have the technical expertise or resources to review and pass on these matters. Therefore, we believe that if the Commission determines to require the delineation of Methodology Inputs in the investment adviser's policies and procedures, the final rule, or its adopting release, should make clear that the Fund's Board is not required to review or approve these "Methodology Inputs". This would also be consistent with the requirements of Rule 22e-4, wherein the Board is not required, nor expected, to pass on technical matters such as liquidity inputs.

3. We believe it is inappropriate to require the investment adviser to determine, in advance of a decision to invest in a new type of security, the methodology to be employed to fair value such a security. The Proposing Release could be read to require that the investment adviser develop a stand-by list of methodologies to be employed in the

event it determines to invest in a new type of security. We suggest that this ambiguity be removed and the investment adviser not be required to develop methodologies in an abstract context. Moreover, occasionally a Fund may receive a security in connection with a corporate action, such as a merger, spin-off or restructuring. Under the Proposed Rule an investment adviser could be deemed to be in violation if it had not anticipated such an event and maintained a "stand-by" methodology to fair value that instrument.

C. *The Determination of When to Use Fair Value* - The Proposed Rule requires that the investment adviser establish criteria for determining when market quotations are no longer reliable.

1. We strongly oppose this element of the Proposed Rule and ask the Commission to reconsider the viability and appropriateness of this requirement. We believe that it is not possible to define the specific criteria or circumstances that may make a market quotation inherently suspect. The investment adviser should not be limited in questioning the appropriateness of a market quotation by a set of criteria that may have been developed in market conditions very unlike those that might exist at the time the quotation is questioned. At a minimum, the Commission should clarify that the requirement to establish criteria for determining when a market quotation is not reliable may be stated in broad subjective terms and need not lay out specific factual circumstances or conditions.

D. *Pricing Services* - The Proposed Rule requires that the investment adviser establish criteria for the circumstances under which pricing challenges will typically be initiated.

1. As with the proposal discussed in C. above, we strongly oppose this element of the Proposed Rule. We believe it is not possible to foresee and to document all factual circumstances that may make a pricing service quotation suspect. As with C. above, the investment adviser should not be prohibited from challenging, or be forced to challenge, a pricing service quotation merely because one or more prescribed criteria are either met or not met. The Commission should either remove the requirement that criteria be established in advance as to when prices will be challenged or clarify that such criteria can be described in broad subjective terms, not in terms of specific factual conditions. We believe that a Board can effectively monitor the use of pricing challenges and overrides through the Proposed Rules back-testing and Board reporting mechanisms.

E. *Policies and procedures* -The Proposed Rule requires that the investment adviser maintain written policies and procedures addressing the determination of fair value. These policies would be subject to Board oversight under Rule 38a-1. The Proposing Release states that to the extent the investment adviser's policies are duplicative of the Fund's policies under Rule 38a-1, the Fund could adopt the adviser's policies in fulfilling its Rule 38a-1 obligation.

1. The Commission should clarify that to the extent a Fund assigns the fair value process to the investment adviser, and if the investment adviser develops policies and procedures that are reasonably designed to comply with Rule 2a-5, the Fund will not be required to have its own policies or to "adopt" the adviser's policies. The

Commission should clarify that in these circumstances, the Board's Rule 38a-1 responsibility is the same with respect to the investment adviser's fair value policies as it is with respect to every other policy and procedure adopted by the investment adviser or a material service provider that is part of the Fund's Rule 38a-1 program; that is to say that the policies and procedures are reasonably designed to prevent violation of the federal securities laws.

F. *Recordkeeping* - The Proposed Rule requires that the Fund maintain, for a five-year period, the first two years in an easily assessible place, certain records relating to the fair value determination, even if the Board has assigned this function to the investment adviser.

1. When the valuation function is assigned to the investment adviser, the Commission should require that the valuation records be maintained by the investment adviser, not the Fund. As the investment adviser is an SEC registered entity, and will maintain all the necessary records as part of its valuation responsibilities, no purpose is served by requiring that the investment adviser transmit a set of these very same materials to the Fund for maintenance as well.

G. *Board oversight* - The Proposing Release contains language indicating that the Commission believes that, even in the event of assignment, Boards should seek to identify conflicts of interest, monitor such conflicts and satisfy themselves that conflicts are being appropriately managed.

1. In circumstances involving assignment, the Commission should clarify that the Board does not have an independent duty to seek to discover conflicts of interest but can reasonably rely on the investment adviser's identification of such conflicts. Of course, the Board cannot ignore obvious conflicts even if the investment adviser does not identify such conflicts; the adopting release for any final rule should make that clear.

H. *Assignment of Valuation Functions* - The Proposed Rule permits assignment of the fair value function only to the investment adviser or sub-adviser.

1. Some Fund groups engage affiliates of the investment adviser, typically through an administration agreement, to perform or assist in the fair value process. The Commission should clarify that the investment adviser may assign the fair value function to its affiliates, provided of course that the affiliate complies with all of the requirements of the Proposed Rule.
2. The Commission should clarify in any adopting release that the investment adviser may engage third parties or delegate certain valuation functions (other than the actual determination of fair value and the selection of methodologies to determine fair value) to third parties, such as unaffiliated Fund administrators, subject to the investment adviser's oversight. This is particularly important for smaller advisers. For example, the process for performing the necessary due diligence of pricing services and performing the back-testing of methodologies, analysis of pricing challenge efficacy, and back-testing of fair value determinations, to name a few, involves a level of resources and manpower that many smaller advisers do not possess. These advisers

typically outsource these functions to administrators, at the cost of the Fund. We are concerned that not allowing such outsourcing will effectively render the mutual fund world out of reach for many smaller advisers, putting them out of business and reducing choice for shareholders. The Commission should provide the investment adviser with the flexibility to delegate the fair value process (other than the actual determination of fair value, and the selection of methodologies to fair value securities) to third parties, such as unaffiliated administrators, provided that these third parties can develop policies and procedures that are reasonably designed to meet the requirements of Rule 2a-5.

I. Board Reporting - The Proposed Rule requires periodic reporting to the Board, including a report in which the investment adviser identifies to the Board the persons responsible for determining the fair value of investments, including the particular functions for which they are responsible and how they segregate the fair value function from portfolio management. The Proposed Rule requires reporting, at least quarterly, of i) the investment adviser's assessment of the adequacy and effectiveness of its fair value process, ii) a summary of the investment adviser's assessment and management of material fair value risks and conflicts of interest of the investment adviser or any material service provider, iii) any material changes in fair value methodologies, iv) the results of the testing of fair value methodologies, iv) the adequacy of resources dedicated to the fair value process, v) any changes to the process for selecting and overseeing pricing services, including information on all price overrides, and vi) any changes to specific valuation roles or functions discussed above. The investment adviser is also required to report "promptly" (but no later than three business days) any matter that materially affected, or could have materially affected the fair value function, including a material weakness or deficiency in the fair value determination process.

1. The Commission should remove the requirement requiring the identification of individuals, titles and specification of functions of individuals responsible for determining fair value. There is a particular lack of clarity as to which individuals are required to be identified. In requiring a delineation of "functions", the Proposed Rule appears to contemplate that there are functions beyond the actual fair value determination that are required to be identified. Little appears to be gained by the mechanical exercise of naming individuals and their titles (which may be generic such as "assistant treasurer" or "compliance officer") and identifying with specificity their roles in the valuation function. This information will likely be meaningless to Boards, who are often not intimately familiar with many employees of the investment adviser, particularly at the back-office level. This is particularly true for large advisers which may have dozens of individuals engaged in the valuation function. This requirement is a mechanical exercise that is not necessary to achieve the purposes of the Proposed Rule.

2. As noted in A.1 above, the Commission should require quarterly reporting of any material changes to material conflicts and material fair value risks and a broader annual report identifying all material conflicts and risks and how they are managed.

3. The Commission should remove the requirement for specific reporting of price overrides and instead allow the Board to rely on the reporting associated with the back testing of fair value methodologies and more general reporting on the operations of the pricing service and the investment adviser's assessment of its processes and operations. Reporting specific information on price challenges is a level of granularity that is inconsistent with the Board's oversight function and not necessary to assess the appropriateness of the valuation process.

4. The Commission should remove the three-day reporting requirement for matters that did or could have materially affected the fair value process. The investment adviser may require more than three days to properly research and verify material pricing issues. Instead, the investment adviser should be required to report to the Board "promptly".

J. Internally-Managed Funds

1. The Commission should clarify that, with respect to internally-managed funds, the Board may assign valuation responsibilities to an officer of the Fund.

We thank the Commission for its consideration of our comments with respect to the Proposed Rule. Please feel free to contact us if we can provide any additional assistance to you as you further evaluate these matters.

Sincerely,

Sullivan & Worcester LLP

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