June 29, 2020

VIA ELECTRONIC SUBMISSION

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File Number S7-07-20; Release IC-33845. Good Faith Determinations of Fair Value.

Dear Ms. Countryman:

I am submitting this second comment letter[1] on my own behalf[2] in response to the April 21, 2020 rulemaking proposal of the Securities and Exchange Commission (the "Commission"): Good Faith Determinations of Fair Value (Release IC-33845, April 21, 2020) (the "Proposing Release").

I. Summary of Comments

The Commission should not adopt proposed rule 2a-5(b), which would permit fund directors to assign their statutory fair valuation responsibilities to fund investment advisers. There are several reasons why the Commission should not adopt proposed rule 2a-5(b).

First, proposed rule 2a-5(b) is contrary to public policy because it would inappropriately put the fox (the investment adviser) completely in charge of the henhouse (valuation) while simultaneously disempowering fund directors.

Second, the premise of proposed rule 2a-5(b) is fundamentally flawed: it rests on the legally incorrect notion that fund directors' assignment of *all* of their statutory fair valuation duties to fund advisers is "appropriate and consistent with the requirements of the Act."

Third, proposed rule 2a-5(b) is fundamentally flawed because it contains no conditions reasonably designed to protect against investment advisers' conflicts of interest when fair valuing fund portfolio securities. As a result, the rule is extremely likely to lead to more valuation-related fraud and substantial monetary harm to fund investors.

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[1] I submitted my first comment letter on proposed rule 2a-5 on May 29, 2020, arguing that the Commission should not rescind its prior valuation guidance, including the guidance contained in Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118 ("ASR 118"). Rescinding ASR 118 would allow funds to inflate the value of their odd lot positions and thus freely engage in the fraudulent and manipulative practices that have been the subject of several SEC enforcement actions.

[2] Please refer to my May 29, 2020 comment letter for my background and qualifications to comment on valuation issues.

Fourth, proposed rule 2a-5(b) is not an exemptive rule, yet exemptive relief is legally required to permit fund directors to assign their fair valuation duties to fund investment advisers. Proposed rule 2a-5(b), therefore, is not legally viable: fund directors who assign their fair valuation responsibilities to fund advisers under proposed rule 2a-5(b) would violate other provisions of the Act.

The Commission also should not rescind its prior valuation guidance. Rescinding ASR 118 would inappropriately and unnecessarily call into question whether fund boards could, consistent with the Act, appoint others to assist them in making determinations of fair value and in making the actual calculations of fair value pursuant to the boards' direction.

The Commission should issue valuation guidance on fund-unique issues that are not addressed by FASB ASC Topic 820.

II. Proposed rule 2a-5(b) is against public policy because it would inappropriately put the fox (the investment adviser) completely in charge of the henhouse (valuation) while simultaneously disempowering fund directors.

Proposed rule 2a-5(b) is against public policy because it would inappropriately put the fox (the fund investment adviser) completely in charge of the henhouse (valuation). Eighty years ago, Congress wisely decided that fund investment advisers were far too conflicted to value fund assets, and Congress further decided that fund directors – the only effective check on fund investment advisers -- should have the power and responsibility for determining the fair value of fund assets.

Proposed rule 2a-5(b) would change all that by placing fund investment advisers completely in charge of fair valuation,[3] even though they would have serious conflicts of interest when doing so. Fund investment advisers have strong economic incentives to unlawfully increase their advisory fees by inflating the fair value of fund assets, overstating fund performance, and inducing investors to invest in their funds based upon that inflated performance. Indeed, the economic pressures on fund investment advisers to inflate the value of fund assets and to inflate fund performance are higher and stronger now than they may have ever been.[4] Proposed rule 2a-5(b) thus directly contravenes a fundamental investor protection that has served and protected fund investors quite well since the enactment of the Investment Company Act in 1940.

Proposed rule 2a-5(b) is extremely likely to lead to more valuation-related fraud and substantial monetary harm to fund investors. Numerous SEC enforcement actions demonstrate

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[3] Although proposed rule 2a-5(b) would permit fund directors the option to retain the responsibility for fair valuation, the Commission believes that the vast majority of fund directors would not do so. Proposing Release at page 99.

[4] The fund industry is far more competitive than it was just a decade or two ago. Fund investment advisers are facing unprecedented competition from their fellow fund managers, and fund investors are increasingly pressuring investment advisers of actively managed funds to produce returns that meet or exceed the returns of indexes while charging lower and lower expenses.

the abuses that can occur when fund investment advisers value fund portfolio securities[5] and when fund directors delegate their fair valuation responsibilities to the fund advisers.[6]

The Act specifically designates fund directors as responsible for fair valuation for a very good reason: not because fund directors are valuation experts, but rather because fund directors serve as the only effective check on the conflicts of interest of the fund's investment adviser. With that responsibility comes power. Because fund directors have the legal responsibility for fair valuation – and the corresponding legal liability for failing to determine fair value in good faith – the fund directors are empowered and incentivized to act responsibly. Acting responsibly means actively deciding which fair valuation methods are used by the fund and taking

[5] *See, e.g.,* In the Matter of The Bank of California, N.A., Investment Company Act Release No. 19545 (June 28, 1993) (settlement); SEC v. Corporate Capital Resources, Inc., *et al.,* Litigation Release Nos. 13460 (Dec. 7, 1992) and 13751 (Aug. 9, 1993) (settlement); In the Matter of Concourse Capital Asset Management, Inc. and Jeffrey J. Alexopulos, Investment Company Act Release No. 20698 (Nov. 15, 1994) (settlement); In the Matter of Thomas M. Rogge, Investment Company Act Release No. 20908 (Feb. 22, 1995) (settlement); SEC v. Vintage Group, Inc., *et al.*, Litigation Release Nos. 13994 (Mar. 7, 1994), 14319 (Nov. 2, 1994), 14350 (Dec. 8, 1994), 14557 (July 12, 1995) and 14597 (Aug. 9, 1995) (settlement); Van Kampen American Capital Asset Management, Inc., Investment Advisers Act Release No. 1525 (Sept. 29, 1995) (settlement); In the Matter of Anthony J. Negus, Investment Company Act Release No. 22535 (Feb. 28, 1997) (settlement);In the Matter of Mitchell Hutchins Asset Management Inc., Investment Company Act Release No. 22805 (Sept. 2, 1997) (settlement); In the Matter of Stephen H. Brown, Investment Company Act Release No. 23434 (Sept. 14, 1998) (settlement); In the Matter of Parnassus Investments, *et al.*, Initial Decision Rel. No. 131 (Sept. 3, 1998), *initial dec. final*, Securities Exchange Act Release No. 40534 (Oct. 8, 1998); In the Matter of John E. Backlund, *et al.*, Investment Company Act Release No. 23639 (Jan. 11, 1999) (settlement); In the Matter of Michael P. Traba, Investment Company Act Release No. 23952 (Aug. 19, 1999) (settlement); In the Matter of Ellen Griggs, Investment Advisers Act Release No. 1836 (Sept. 27, 1999) (settlement); In the Matter of John Wellington Bagwell, Investment Company Release No. 24934 (Apr. 10, 2001) (settlement); In the Matter of Trudie D. Whitehead, Investment Company Act Release No. 25198 (Sept. 28, 2001) (settlement); In the Matter of Kyle R. Kirkland, Investment Company Act Release No. 25199 (Sept. 28, 2001) (settlement); In the Matter of Judy M. Rupay and Dixon R. Holman, Investment Company Act Release No. 25960 (Mar. 4, 2003) (settlement); In the Matter of Piper Capital Management, Inc., *et al.*, Investment Company Act Release No. 26167 (Aug. 26, 2003); In the Matter of FT Interactive Data, f/k/a Interactive Data Corp., Investment Company Act Release No. 26291 (Dec. 11, 2003) (settlement); In the Matter of Garrett Van Wagoner and Van Wagoner Capital Management, Inc., Investment Company Act Release No. 26579 (Aug. 26, 2004) (settlement); In the Matter of The Rockies Fund, Inc., *et al.*, Investment Company Act Release No. 26202 (Oct. 2, 2003); *aff'd in part, rev'd in part and vacated as to sanction*, 428 F.3d 1088 (D.C. Cir. 2005); In the Matter of Allied Capital Corp., Securities Exchange Act Release No. 55931 (June 20, 2007) (settlement); In the Matter of Heartland Advisors, Inc., *et al.*, Investment Company Act Release No. 28136 (Jan. 25, 2008) (settlement); In the Matter of Evergreen Investment Management Company, LLC, *et al.*, Investment Company Act Release No. 28759 (June 8, 2009) (settlement); In the Matter of Robert John Hipple, Investment Company Act Release No. 29173 (Mar. 11, 2010) (settlement); In the Matter of Robert P. Pinkas, Investment Advisers Act Release No. 3097 (Oct. 5, 2010) (settlement); In the Matter of Morgan Asset Management, Inc., *et al.*, Investment Company Act Release No. 29704 (June 22, 2011) (settlement); In the Matter of UBS Global Asset Management (Americas) Inc., Investment Company Act Release No. 29920 (Jan. 17, 2012) (settlement); In the Matter of KCAP Financial, Inc., *et al.*, Securities Exchange Act Release No. 68307 (Nov. 28, 2012) (settlement); In the Matter of Lisa B. Premo, Initial Decision Rel. No. 476 (Dec. 26, 2012); *initial dec. Final*, Investment Company Act Release No. 30372 (Jan. 30, 2013); In the Matter of Oppenheimer Asset Management Inc., *et al.*, Investment Advisers Act Release No. 3566 (Mar. 11, 2013) (settlement); In the Matter of Calvert Investment Management, Inc., Investment Advisers Act Release No. IA-4554 (Oct. 18, 2016) (settlement); Pacific Investment Management Company LLC, Investment Advisers Act Release No. IA-4577 (Dec. 1, 2016) (settlement).

[6] *See, e.g.,* In the Matter of Morgan Asset Management, Inc., Investment Advisers Act Rel. No. 3009 (Apr.7, 2010); In the Matter of J. Kenneth Alderman, *et al.*, Investment Company Act Rel. No. 30557 (June 13, 2013); In the Matter of Jon D. Hammes, *et al.*, Investment Company Act Release No. 26290 (Dec. 11, 2003) (settlement).

responsibility for ensuring that those fair valuation methods continue to be appropriate for the fund. Acting responsibly also means actively using the power entrusted to them by the Act to obtain any and all relevant information from the fund's investment adviser to enable fund directors to faithfully carry out their fair valuation responsibility. Having the legal responsibility for fair valuation empowers fund directors to direct the fund's investment adviser to carry out the directors' fair value determinations faithfully.

The Act thus *empowers* fund directors with the responsibility for fair valuing the fund's securities so that they may serve as an effective check on the fund's investment adviser, which – in most cases – controls the fund[7] and which – in any event – has a very strong incentive to inflate the value of the fund's assets. The fair valuation power and responsibility give fund directors the leverage that they need to ensure that the fund's fair valuations are determined appropriately and consistent with the Act.

Proposed rule 2a-5(b), however, would *disempower* fund directors. Fund directors would be relieved of their statutory fair valuation responsibility and permitted to "assign" that responsibility to the very entity from which the Congress wisely withheld that responsibility 80 years ago. That is a potent combination that is extremely likely to lead to more valuation-related fraud and substantial economic harm to fund investors.

Many fund boards have become quite adept at managing their fair valuation responsibilities. The solution is for more fund boards to also become adept at managing their fair valuation responsibilities,[8] and not for the SEC to permit fund boards to delegate or assign their fair valuation responsibilities to fund investment advisers.

The SEC should not adopt rule 2a-5(b) permitting fund directors to delegate or assign their statutory fair valuation responsibilities to fund investment advisers.

III. The premise of proposed rule 2a-5(b) is fundamentally flawed: it rests on the legally incorrect notion that fund directors' assignment of *all* of their statutory fair valuation duties to fund investment advisers would be "appropriate and consistent with the requirements of the Act."

Proposed rule 2a-5(b) would permit fund boards to "assign" their statutory responsibility to make fair value determinations to fund investment advisers. The premise of proposed rule 2a-5(b), however, is fundamentally flawed: it rests on the legally incorrect notion that the directors' assignment of *all* of their statutory fair valuation duties to fund advisers would be "appropriate and consistent with the requirements of the Act."[9]

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[7] Section 2(a)(9) of the Investment Company Act defines "control" as "the power to exercise a controlling influence over the management or policies of a company…." Indeed, the Commission has stated that "the investment adviser almost always controls the fund." *In the Matter of Steadman Security Corporation, et al*., 46 S.E.C. 896, 920 (June 29, 1977).

[8] The requirements of proposed rule 2a-5(a) would help fund directors become more adept at managing their fair valuation responsibilities.

[9] Proposing Release at section II. B., page 33.

Proposed rule 2a-5(b), if adopted, would completely transform the fair valuation process for funds. Currently, the Act requires fund boards to make fair valuation determinations, although fund investment advisers may assist the fund boards by making the actual calculations of fair values pursuant to the boards' direction. In contrast, under the proposed rule, directors would be permitted to "assign" all of their statutory fair valuation responsibilities to fund investment advisers.

The Act does not currently permit fund directors to assign their fair valuation responsibilities to fund investment advisers. Indeed, it is prohibited by the Act. The Commission has taken this position in enforcement actions,[10] and the Commission expressly acknowledged in the Proposing Release that "a fund's board may not delegate the determination of fair value to anyone else."[11]

In describing proposed rule 2a-5(b), however, the Commission incorrectly states otherwise. Indeed, after describing how fund directors currently enlist fund investment advisers to perform some valuation-related functions, such as daily net asset value calculations, the Commission states that "[w]e continue to believe that allocating day-to-day responsibilities to an investment adviser, subject to robust oversight, is appropriate and consistent with the requirements of the Act."[12]

Proposed rule 2a-5(b), however, would do much more than allocate "day-to-day" fair value responsibilities to fund investment advisers. The proposed rule would allocate *all* of the fair valuation responsibilities from fund directors to fund investment advisers, which is prohibited by the Act. Thus, the proposed rule is NOT consistent with the requirements of the Act, which places fair valuation responsibilities exclusively upon fund directors.

Accordingly, the premise of proposed rule 2a-5(b) is fundamentally flawed: it rests on the legally incorrect notion that the directors' assignment of *all* of their statutory fair valuation duties to fund advisers would be "appropriate and consistent with the requirements of the Act."[13]

IV. Proposed rule 2a-5(b) is also flawed because it includes no protective conditions reasonably designed to address the investment advisers' conflicts of interest when fair valuing fund portfolio securities, unlike many other rules under the Act that permit fund investment advisers to act in conflicted capacities.

The Commission expressly recognizes in the Proposing Release that investment advisers would have serious and substantial conflicts of interest when they determine the fair values of fund portfolio securities.[14] Yet, the Commission proposes no substantive or procedural requirements reasonably designed to ensure that fund investment advisers would not act in their own self-interest when fair valuing fund portfolio securities. Instead, the Commission has apparently deferred to fund boards "to establish a framework … to effectively oversee the

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[10] *See, e.g., In the Matter of J. Kenneth Alderman*, *et al.*, Investment Company Act Release No. 30557 (June 13, 2013) (settlement).
[11] Proposing Release at section II. B., page 31 (citations omitted).
[12] Id. at section II. B., page 33.
[13] Id.
[14] Id. at section II. B., page 15.

investment adviser through the proposed rule, in light of the adviser's conflict of interest…."[15] The rule, however, *does not require fund directors to do so*.

In several instances, the Commission has adopted rules under the Investment Company Act to permit fund investment advisers to act in conflicted capacities. But in each of those rules, the Commission has also mandated procedural and substantive protections that are reasonably designed to police the advisers' conflicts of interest. *See, e.g.,* rule 12b-1, rule 10f-3, and rules 17a-7, 17a-8 and 17a-9 under the Investment Company Act. Proposed rule 2a-5(b), however, contains no protective conditions reasonably designed to address the conflicts that fund investment advisers would face when they determine fair values.[16] Without such protective conditions, proposed rule 2a-5(b) is extremely likely to lead to more valuation-related fraud and substantial economic harm to fund investors.

V. Proposed rule 2a-5(b) is not an exemptive rule, yet exemptive relief is required to permit fund directors to assign their fair valuation duties to fund investment advisers.

The only legally permissible way for the Commission to change the Investment Company Act by shifting the statutory fair valuation responsibilities from fund directors to fund investment advisers would be by issuing exemptive relief, either by adopting an exemptive rule or by issuing an exemptive order. Put another way, under the Act, the directors are effectively prohibited from assigning their fair valuation duties to anyone else, unless they are permitted to do so either by exemptive rule or by exemptive order.

Proposed rule 2a-5(b), however, does not purport to be an exemptive rule.[17] In particular, the proposed rule does *not* exempt funds or their directors from liability under the Investment Company Act that may result from the directors failing to determine the fair values of fund portfolio securities.[18] Nor does the proposed rule exempt fund directors from liability under the Investment Company Act that may result from assigning their statutory fair valuation responsibilities to fund investment advisers.[19]

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[15] Id.

[16] While proposed rule 2a-5 includes reporting and other conditions, those conditions are essentially the same regardless of whether fund directors retain their fair valuation duties or assign them to the fund investment advisers.

[17] The only suspicion that proposed rule2a-5(b) might possibly be an exemptive rule is the Commission's *unexplained* citation to section 6(c) of the Investment Company Act in section VII of the Proposing Release, the section entitled "Statutory Authority."

[18] As previously noted, section 2(a)(41)(B) of the Investment Company effectively requires fund directors to make fair valuation determinations. That section does so, however, by defining the term "value." Exempting directors from liability for making fair valuation determinations thus cannot be achieved by granting exemptive relief from section 2(a)(41)(B), because that section does not make it unlawful for directors to fail to make fair valuation determinations; it merely defines "value" to include determinations of fair value by fund directors. (The Commission cannot grant exemptive relief from statutory definitions. Rather, exemptive relief issued by the Commission exempts natural persons and companies from liability for failing to comply with certain provisions of the Investment Company Act.) Instead, the Commission would need to issue exemptive relief to funds and their directors exempting them from various provisions of the Act that require funds to make net asset valuation determinations, such as rule 22c-1 and section 30.

[19] For example, the proposed rule could have exempted funds from liability under rule 22c-1 under the Investment Company Act, which prohibits funds from issuing and redeeming their shares except at their per share net asset values (including the values of any securities required to be fair valued by fund directors). In addition, proposed

If proposed rule 2a-5(b) were an exemptive rule, the Commission would certainly have stated in the Proposing Release that the proposed rule was an exemptive rule. In addition, if proposed rule 2a-5(b) were an exemptive rule, (a) the Proposing Release and the proposed rule would have identified each and every provision of the Investment Company Act that funds and their directors would be exempted from complying with, and (b) the Proposing Release would have explained and justified why exemptive relief from liability under those provisions was warranted. The Proposing Release and the proposed rule, however, did not do so.

In sum, exemptive relief is necessary to change the Investment Company Act to shift the statutory fair valuation responsibilities from fund directors to fund investment advisers. Because proposed rule 2a-5(b) does not purport to be an exemptive rule, and because the Proposing Release and proposed rule 2a-5(b) do not purport to grant exemptive relief from complying with specific provisions of the Investment Company Act, proposed rule 2a-5(b) is not legally viable: fund directors who assign their fair valuation responsibilities to fund advisers under proposed rule 2a-5(b) would violate other provisions of the Act.[20]

VI. Rescinding ASR 118 would be extremely ill-advised because it would eliminate a key interpretation that fund directors (a) currently rely upon when fulfilling their fair valuation responsibilities and (b) would seek to continue to rely upon if they retained their fair valuation responsibilities after the adoption of rule 2a-5.

In the Proposing Release, the Commission announced that it proposes to rescind its prior valuation guidance, including the guidance in ASR 118. Rescinding ASR 118 would be extremely ill-advised: *rescinding ASR 118 would inappropriately and unnecessarily call into question whether fund boards could, consistent with the Act, appoint others to assist them in making determinations of fair value and in making the actual calculations of fair value pursuant to the boards' direction.*

ASR 118 contains a key interpretive position of the Commission. Section 2(a)(41)(B) of the Investment Company Act imposes upon fund directors the responsibility for fair valuing fund securities and other assets. ASR 118 interprets and clarifies how fund directors may comply with and fulfill their statutory fair valuation responsibilities in an efficient and productive manner, without having to engage in certain time-consuming valuation-related tasks that can be assigned to a third party.

Fair valuation was a time-consuming task back in 1940, when (a) individuals typically served as fund directors for only one or a small number of funds, (b) funds primarily invested in securities for which market quotations were readily available and (c) funds typically invested in only a few securities that required fair valuation.

By 1970, however, when the Commission issued ASR 118, many things had changed. Fund directors had begun to typically serve on the boards of multiple funds, and those funds invested

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rule 2a-5 could have exempted funds and their directors from liability under sections 30 and 34(b) of the Investment Company Act for issuing periodic reports that include financial statements listing the values of fund securities (including the values of any securities required to be fair valued by fund directors).

[20] *See* footnotes 17-18, *supra*.

far more frequently in securities that required fair valuation. In other words, by 1970, the burden of fair valuation on fund directors had substantially increased. In response, some fund boards took affirmative steps to efficiently and productively address the increased burden. These fund boards continued to authorize the *fair valuation methodologies* to be used by their funds when making fair value determinations, but they appointed others, typically the funds' investment advisers, to assist them in making fair value determinations and to make the actual *calculations* pursuant to the boards' directions.

These fund directors, however, found themselves in a legal limbo of sorts. While they reasonably believed that their actions complied with and fulfilled their statutory responsibilities, they recognized that the Act literally required that directors must perform *all* of functions of determining the fair value of each security in fund portfolios. Indeed, the Act indicates that fund directors must not only determine the fair valuation *methodology* to be used for each portfolio security, but also that fund directors must themselves also *apply* those methodologies and *calculate* the fair value of each portfolio security, without the assistance of others, such as the fund's investment adviser.

In ASR 118, the Commission expressly acknowledged that the efficient fair valuation practices employed by these fund boards fulfilled and complied with the fund directors' statutory responsibilities under the Investment Company Act. In ASR 118, the Commission stated that:

> To comply with section 2(a)(39)[21] of the [Investment Company] Act, and rule 2a-4 (17 CFR 270.2a-4) under the Act, it is incumbent upon the Board of Directors to satisfy themselves that all appropriate factors relevant to the valuation of securities for which market quotations are not readily available have been considered and to determine the method of arriving at the fair value of each such security. *To the extent considered necessary, the board may appoint persons to assist them in making the determination of such value, and to make the actual calculations pursuant to the board's direction* …. The directors must recognize their responsibilities in this manner and whenever technical assistance is requested from individuals who are not directors, the findings of such individuals must be carefully reviewed by the directors in order to satisfy themselves that the resulting valuations are fair (emphasis added). [22]

Accordingly, in ASR 118, the Commission interpreted the Act such that directors would fulfill their fair valuation responsibilities if they determined the fair valuation methodologies to be used by the fund, and that – consistent with the Act -- the directors could appoint others to make the

[21] When ASR 118 was issued, section 2(a)(39) of the Act contained the relevant statutory provisions that are currently contained in section 2(a)(41) of the Act.

[22] In 1969, the Commission issued Accounting Series Release No. 113 ("ASR 113"). Statement Regarding "Restricted Securities," Investment Company Act Release No. 5847 (Accounting Series Release No. 113) (Oct. 21, 1969). In ASR 113, the Commission made a similar statement, *i.e.,* "The actual calculations [of fair value] made be made by persons acting at the direction of the board."

actual calculations of the fair values, provided that the directors carefully reviewed those calculations to ensure that the resulting valuations were fair.

To this day, fund directors continue to rely on the interpretive guidance contained in ASR 118. That is, fund boards continue to determine the fair valuation methodologies to be used by their funds, but they also obtain assistance from fund investment advisers in deciding which fair valuation methodologies to use, and the investment advisers make the actual fair value calculations pursuant to the direction of the fund boards.

In the event that the Commission adopts proposed rule 2a-5, however, some fund boards of directors may decide, as permitted by the proposed rule, *not* to assign their fair valuation responsibilities to their funds' investment advisers and would continue to retain and seek to comply with their statutory fair valuation responsibilities. Such fund boards, no doubt, would seek to so in an efficient and productive manner, and would wish to continue to employ others, including their funds' investment advisers, to assist them with their fair valuation duties, including making the actual fair value calculations for each security pursuant to the boards' directions.

Rescinding ASR 118 and its interpretive guidance would inappropriately and unnecessarily call into question whether fund boards could, consistent with the Act, appoint others to assist them in making determinations of fair value and in making the actual calculations of fair value pursuant to their direction. Proposed rule 2a-5 is silent on this issue, and GAAP and FASB ASC Topic 820 do not address the issue either.

Rescinding ASR 118, therefore, would be extremely ill-advised. At a minimum, the Commission should preserve the interpretive guidance in ASR 118 that expressly permits each fund board to appoint persons to assist them in making fair value determinations, and to make the actual calculations pursuant to the board's direction.

VII. <u>The Commission should issue valuation guidance on issues that are unique to funds and that FASB ASC Topic 820 does not address</u>.

The proposed rule, if adopted by the Commission would cause funds, fund boards and fund investment advisers to spend thousands of hours and *billions* of dollars when making the procedural changes necessary to comply with the rule's requirements.[23] Instead of causing these immense costs, *the Commission should actually provide fair valuation guidance to funds, fund directors and fund investment advisers.*

The Commission has previously promised that it would provide comprehensive valuation guidance, and such guidance is badly needed and long overdue. While FASB ASC Topic 820 does provide clarity on a number of fair valuation issues for funds, it does not provide guidance on regularly occurring issues that are *unique* to funds. The Commission should provide guidance on such issues.

[23] Proposing Release at page 99.

For example, the Commission should address the following valuation-related issues that are unique to funds:

1. **Whether index-based funds, including index-based exchange-traded funds ("ETFs"), are required to fair value their exchange-traded portfolio securities when the closing prices of those securities are stale.**

The Commission should issue guidance concerning whether index-based funds and ETFs are required to fair value their exchange-traded portfolio securities with stale closing prices when doing so would cause tracking error or when index-based ETFs exclusively use in-kind transactions for purchases and redemptions of their shares.

Some index funds and index-based ETFs argue that they should not be required to fair value their exchange-traded portfolio securities when the closing prices of those securities are stale. They assert that the use of fair values, rather than closing prices, would result in "tracking error," *i.e.*, a divergence between the performance of the funds and the performance of the relevant index. In addition, some index-based ETFs that sell and redeem their shares only through in-kind transactions argue that their exclusive use of in-kind transactions for all purchases and redemptions of ETF shares eliminates the need to fair value their exchange-traded portfolio securities when the closing prices of those securities are stale. FASB ASC Topic 820 does not address these issues.

2. **Whether business development companies ("BDCs") may use the enterprise valuation methodology ("EVM") to fair value their portfolio securities.**

The Commission should issue guidance concerning whether, and if so under what circumstances, BDCs can use EVM, the enterprise valuation methodology, to fair value their portfolio securities.

Many BDCs use EVM to fair value their portfolio securities. EVM is based on the valuation of the entire portfolio company; BDCs determine the enterprise or "going concern" value of a portfolio company and then allocate that value to the outstanding capitalization of the company as of the valuation date, thereby deriving the portion of the enterprise value that is attributable to the portfolio securities owned by the BDCs. EVM often results in the valuation of debt securities at par, a practice which appears to ignore interest rate fluctuations and risks faced by the portfolio company. The Commission has observed that funds should not ignore changes in interest rates when valuing debt securities,[24] and the Commission has brought an enforcement action against a BDC for using EVM to fair value debt securities issued by portfolio companies that the BDC did not control.[25] FASB ASC Topic 820 does not address this issue.

3. **Whether funds may use block discounts or premiums for large holdings of portfolio securities, and whether funds are required to fair value portfolio securities that are owned in "odd lots."**

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[24] *See Report of Investigation in The Matter of Greater Washington Investors, Inc.*, 1934 Act Rel. No. 15673 (Mar. 22, 1979). *See also* ASRs 113 and 118.
[25] *See In the Matter of KCAP Financial, Inc., et al.*, 1934 Act Rel. No. 68307 (Nov. 28, 2012).

The Commission should issue guidance concerning whether, and if so under what circumstances, funds may use block discounts or premiums to value large holdings of portfolio securities, and whether funds are required to fair value portfolio securities that are owned in "odd lots."

Some funds have questioned whether a fund may value an unrestricted security at a "block discount" or "block premium" (*i.e.*, a discount from the readily available market quotations for that security based solely on the large size of the fund's holding relative to the average daily trading volume of the security, or a premium to the readily available market quotations for that security based solely on the large size of the fund's holding relative to the total number of the issuer's outstanding securities, respectively). Prior Commission guidance suggests that funds, when valuing their portfolio securities, should take into consideration the number of shares of portfolio securities that they own,[26] whereas FASB ASC Topic 820 suggests otherwise. The Commission also has indicated in an enforcement action that funds are required to fair value portfolio securities that are owned in "odd lots."[27] I previously raised a similar issue in my comment letter dated May 29, 2020.

These are only a few examples of valuation-related issues that are unique to funds and that the Commission should address.[28] Providing valuation-related guidance would provide badly needed clarity and transparency to funds, fund directors and fund investment advisers, as well as to Commission examiners, Commission enforcement investigators and staff in the Division of Investment Management. Without Commission guidance, these issues will continue to be the point of contention within the fund industry and may (unnecessarily) be decided in the context of Commission enforcement actions. That is and would be unfortunate.

VIII. Conclusion

The Commission should not adopt proposed rule 2a-5(b). The premise of the rule is fundamentally flawed, and the proposed rule is contrary to public policy because it would inappropriately put the fox (the investment adviser) completely in charge of the henhouse (valuation) while simultaneously disempowering fund directors. The proposed rule also is flawed because it includes no protective conditions reasonably designed to address the investment advisers' conflicts of interest when fair valuing fund portfolio securities. The proposed rule is not legally viable because it is not an exemptive rule, yet exemptive relief is required to permit fund directors to assign their fair valuation duties to fund investment advisers. If adopted, the proposed rule would be extremely likely to lead to more valuation-related fraud and substantial economic harm to fund investors.

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[26] ASR 118.

[27] *In the Matter of Pacific Investment Management Company LLC*, Investment Advisers Act Rel. No. 4577 (Dec. 1, 2016).

[28] For examples of other issues about which the Commission should issue valuation guidance, *see* Douglas Scheidt, *Whither Valuation Guidance?,* Fund Board Views, Dec. 6, 2019, available at http://fundboardviews.com/Content_Free/Viewpoints-Scheidt-valuation.aspx.

The Commission also should not rescind its prior valuation guidance. Rescinding ASR 118 would inappropriately and unnecessarily call into question whether fund boards could, consistent with the Act, appoint others to assist them in making determinations of fair value and in making the actual calculations of fair value pursuant to the boards' direction.

The Commission should issue valuation guidance on fund-unique issues that are not addressed by FASB ASC Topic 820.

Very truly yours,

Douglas Scheidt