

July 15, 2020

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

Re: Good Faith Determinations of Fair Value (File No. S7-07-20)

Dear Ms. Countryman:

J.P. Morgan Asset Management (“JPMAM”)<sup>1</sup> is pleased to respond to the Securities and Exchange Commission’s (the “SEC” or the “Commission”) proposed rule on the good faith determinations of fair value of the investments of a registered investment company or business development company (the “proposed rule”).<sup>2</sup> JPMAM currently offers 154 mutual funds and ETFs in the US, with a total of approximately \$885.5 billion in assets under management at the end of June 2020.

JPMAM supports the SEC’s goal of providing an updated regulatory framework for the fair valuation practices of registered investment companies (“funds”). The proposed rule sets forth a comprehensive approach to valuation, which is critical for accurate financial reporting and calculating a fund’s net asset value, performance, and fees. While a fund’s board of directors is responsible for fair valuation,<sup>3</sup> a fund’s investment adviser plays an important role in this process. The proposed rule’s approach to articulating the important role of a fund’s investment adviser is a welcome development.

The Commission last comprehensively addressed valuation practices and the role of the board in a pair of Accounting Series Releases issued in 1969 and 1970.<sup>4</sup> Since then, markets and fund

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<sup>1</sup> J.P. Morgan Asset Management is a marketing name for the investment management subsidiaries of JPMorgan.

<sup>2</sup> Good Faith Determinations of Fair Value, Release No. IC-33845 (Apr. 21, 2020), 85 Fed. Reg. 28734 (May 13, 2020) (“Proposing Release”).

<sup>3</sup> For purposes of valuing fund investments, the Investment Company Act of 1940 defines “value” as the market value of the investment if market quotations are readily available. If market quotations are not readily available, the investment must be valued at its “fair value as determined in good faith by the board.” Section 2(a)(41) of the Investment Company Act of 1940.

<sup>4</sup> Statement Regarding “Restricted Securities,” Accounting Series Release No. 113 (Oct. 21, 1969); Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118 (Dec. 23, 1970). The

investment practices have evolved considerably. Funds today hold a wide variety of investments, many of which do not have readily available market quotations. These include a majority of fixed income and debt instruments, less liquid equity securities, over-the-counter derivatives, and other illiquid and non-marketable investments. Given the broad range of investment strategies that we offer, we rely heavily on fair valuation.

As the Proposing Release explains, the absence of modernized regulation has led boards to seek clarity on how they can effectively fulfill their fair valuation obligations while seeking the assistance of others.<sup>5</sup> Thus, the Commission's effort to set forth an updated and comprehensive regulatory framework that addresses fair valuation practices and the role of the board is timely and welcome.

We support the SEC's proposed rule, which would: 1) establish a consistent baseline of practices that comprise the fair valuation process, and 2) permit a fund's board to assign fair value determinations to the investment adviser of a fund, subject to certain conditions. We believe the proposed rule thoughtfully addresses the fair valuation process and the roles of the board and fund investment advisers. However, we recommend the following changes:

- While we agree that fair value methodologies should be applied consistently, the investment adviser may determine that a deviation from the specified methodology is in the best interest of the fund and its shareholders. We recommend that the final rule acknowledge that, at times, deviations from the standard methodology may be appropriate, subject to documentation and board oversight.
- We support providing the board a summary assessment of key fair valuation topics, which will enable boards to identify trends, exceptions, and outliers. While we agree that quarterly reporting is appropriate on topics relating to the operation and effectiveness of fair valuation, we believe reporting on the design and implementation of the program, which is typically more static, should be conducted annually.
- We are concerned that the proposed three business-day timeline to provide the board with a report on material issues associated with the fair valuation process is not practicable. We recommend that the investment adviser be required to promptly (within three business days of becoming aware of a matter that is material) provide an initial notification to the board, and subsequently provide a written report following a timely assessment of the issue.

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statements acknowledge that the board need not itself perform each of the specific tasks required to calculate fair value; however, the board would choose the methods used to arrive at fair value, and continuously review the appropriateness of such methods, among other obligations.

<sup>5</sup> Proposing Release at 14.

## **I. Fair valuation of fund investments**

Properly valuing fund investments is critical to fair pricing of fund shares, avoiding dilution of shareholder interests, calculating fees and performance, and complying with investment policies and limitations. Under the proposed rule, the process of fair valuation would require an investment adviser to: assess and manage material risks associated with fair value determinations; select, apply, and test fair value methodologies in a consistent manner; oversee and evaluate any pricing services used; adopt and implement policies and procedures; and maintain certain records. These elements are intended to establish a consistent framework and standard of baseline practices across funds, while deferring to existing accounting standards for detailed guidance on fair value techniques.

Overall, we support the proposed framework because it focuses on the fair valuation process while not setting forth prescriptive valuation methods. This approach will allow us to build upon existing processes, as well as adapt to evolving valuation methods and techniques. However, there may be instances in which deviating from a consistent framework and using an alternate fair value methodology could be in the best interest of a fund and its shareholders. Our comments below focus on ensuring that the final rule provides sufficient flexibility to select and apply appropriate fair value methodologies and initiate price challenges.

### *a. Selecting and applying fair value methodologies in a consistent manner*

The proposed rule would require the establishment and application of a consistent methodology or methodologies for determining (and calculating) the fair value of fund investments.<sup>6</sup> The Proposing Release explains that inconsistent application of methodologies increases the likelihood that a fund's investments will be improperly valued.<sup>7</sup> While we generally agree, there may be times when a deviation from the specified methodology is in the best interests of the fund and its shareholders; we recommend that the final rule allow for this possibility subject to appropriate documentation and oversight.

At JPMAM, our fund valuation policy establishes a hierarchy of pricing services and methodologies for each sub-asset class (e.g., corporate bonds, foreign equities). Valuation is obtained from a primary pricing service unless that service is unable to provide a reliable price; in that instance an alternate pricing service may be used. On occasion, investments may be internally fair valued. This may occur for various reasons, including instances where JPMAM is able to incorporate market events more quickly, source a broader array of inputs, and/or better understand the impact to the affected investment(s) than a pricing service. For example, this may occur following the announcement of a merger, a corporate debt restructuring event, or extreme market volatility (such

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<sup>6</sup> Proposed rule 2a-5(a)(2)(A).

<sup>7</sup> Proposing Release at 20.

as the recent adverse market conditions caused by COVID-19). Although our methodology provides for instances in which internal fair value should be considered, it would not be possible to enumerate all such circumstances in advance and the corresponding methodologies that should be applied. The rationale for deviating from the hierarchy and alternate methodology used is documented and presented to the board on a quarterly basis.

We recommend the final rule recognize that on occasion deviations from established methodologies may be in the best interest of a fund and its investors. In setting forth the requirements to establish and apply fair value methodologies, the final rule could provide for monitoring for circumstances that may necessitate an alternative fair value method. The decision to apply an alternate methodology should depend on the facts and circumstances of the situation and should be reflected in periodic board reporting. The report could include a summary of relevant market conditions or the circumstances around the event(s), the decision to apply an alternate methodology, and the alternate fair value methodology used.

*b. Pricing services and initiating price challenges*

The proposed rule would require oversight of pricing service providers, which includes establishing criteria for initiating price challenges.<sup>8</sup> The Proposing Release explains this would require establishing “criteria for the circumstances under which price challenges typically would be initiated (e.g., establishing objective thresholds).”<sup>9</sup> We are concerned that the reference to objective thresholds could be limiting and may lead to a mechanical price challenge process. We recommend that the Adopting Release make clear that there is flexibility to apply judgment in determining when a price challenge is appropriate.

While JPMAM currently maintains criteria for automatic price challenges, we find that these thresholds typically capture only larger or easily measured price variances. There are various other circumstances in which price challenges may be initiated. As described above, the investment adviser may be in possession of additional market color and information on specific investments, which may be provided to the valuation team as part of the consideration of whether to initiate a price challenge. We recommend the Adopting Release clarify that the investment adviser may exercise judgement and discretion in determining whether to initiate a price challenge (i.e., that challenges are not limited to “objective thresholds”). To ensure proper oversight of this process, the periodic board reporting should summarize how the challenge process has been used, such as the types of reasons for initiating price challenges and the distribution of “up” versus “down” challenges over a given period.

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<sup>8</sup> Proposed rule 2a-5(a)(4)(B).

<sup>9</sup> Proposing Release at 26.

## II. Board oversight and reporting

Fair valuation requires specialized expertise and significant resources, making it impractical for directors themselves to carry out their fair value duties without input and assistance. The proposed rule would permit the board to assign the determination of fair value to a fund's investment adviser, subject to periodic and prompt reporting, recordkeeping and other requirements designed to facilitate board oversight. We strongly support this approach. In our experience, boards currently rely on fund investment advisers to perform the day-to-day fair valuation tasks. The proposed rule provides boards with clear and consistent guidance as to how they may do so while fulfilling their statutory obligations. Below we offer comments on the provision of information to the board.

### *a. Periodic board reporting*

The proposed rule would require the investment adviser, at least quarterly, to provide the board a written assessment of the adequacy and effectiveness of its process for determining the fair value of the assigned portfolio of investments.<sup>10</sup> These reports must include, at a minimum, a summary or description of certain elements, and are designed to support the board's evaluation of the investment adviser's process for determining fair value.<sup>11</sup> We believe this requirement will ensure the board has the necessary information to execute its oversight responsibilities. However, we recommend that certain of the required elements be provided annually, rather than quarterly, with more frequent updates only as necessary.

We agree that the investment adviser should provide the board regular updates on the fair value process. We also strongly support the proposed ability to provide this information in a variety of formats that may be useful to the board, such as summaries, graphical representations, and dashboards. These formats will enable boards to identify trends, exceptions, and outliers more effectively than the detailed reports typically provided today, such as a list of each investment that was assigned a fair value.

However, we believe that several of the enumerated elements required in the periodic reports experience little or no change each quarter, including the risk assessment, description of methodologies, and assessment of resources and pricing services. Although it would be possible to report more frequently on these topics, we are concerned that repetitious updates would become rote and distract director attention. We recommend that these topics be addressed in a separate annual report to the board focused on the design and implementation of the investment adviser's

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<sup>10</sup> Proposed rule 2a-5(b)(1)(i).

<sup>11</sup> The required elements would cover: material valuation risks, material changes to or material deviations from methodologies, testing results, the adequacy of resources allocated to fair valuation, pricing services, and any other information requested from the board. *See* proposed rule 2a-5(b)(1)(A) through (F).

fair value process.<sup>12</sup> Any material changes to these elements could be addressed in the following quarterly report.

A quarterly report would then focus on the operation and effectiveness of the fair value program. This could include summary results of fair value testing, trends, emerging risk areas, and any other information the board requests. These topics are more dynamic and suitable for more frequent reporting. Further, this approach would provide sufficient frequency for boards to exercise the level of oversight contemplated by the proposed rule.

*b. Prompt board reporting*

The proposed rule would require the investment adviser to report promptly (but in no event later than three business days after the investment adviser becomes aware of a material matter) on matters associated with the investment adviser's process that materially affect or could have materially affected the fair value of the assigned portfolio of investments.<sup>13</sup> Although the proposed rule does not specify the contents of the prompt notification, the Proposing Release explains that the report "must include such information as may be reasonably necessary for the board to evaluate the matter covered in the report."<sup>14</sup> We are concerned that in some circumstances it may not be possible to deliver this information within three business days. Additionally, we believe that matters that "could have materially affected" fair value (but did not) do not typically warrant the board's immediate attention; reporting on these matters should be deferred to the next board meeting.

With respect to material process-related issues, the identification, assessment of materiality, root-cause investigation, and final resolution can be complex and time consuming. Once identified, the investment adviser may need to gather information from various business units and pricing services and investigate the operation of multiple processes. In our experience, a preliminary assessment alone can take more than three days in some cases. In such cases, it would not be possible to deliver a written report within the proposed timeframe that contains enough information to enable directors to evaluate the matter at hand.

We recommend that the final rule instead require the investment adviser to provide the board an initial notification of a reportable matter within three business days of identifying a matter that has been determined to be material, followed by a written report after a more thorough analysis. The initial notification could be provided orally (with documentation) or in writing and should include a brief description of the issue and a summary of the initial assessment of materiality. Following the investigation and analysis, the investment adviser would provide a written report to support the

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<sup>12</sup> We observe this approach is consistent with Rule 22e-4 (17 C.F.R. § 270.22e-4) in which a fund's board would review, no less than annually, the investment adviser's summary of its liquidity risk management program.

<sup>13</sup> This would include a significant deficiency or material weakness in the design or implementation of the investment adviser's fair value determination process or material changes in a fund's valuation risks. *See* Proposed rule 2a-5(b)(1)(ii).

<sup>14</sup> Proposing Release at 49.

board's evaluation of the matter. This report would be provided to the board as soon as reasonably practicable.

Finally, we do not believe that it is necessary to promptly notify the board on matters associated with the investment adviser's process that "could have materially affected" fair value. For example, if an issue affected a small investment that did not have a material impact on its own, but could have materially affected fair value had the position size been larger, we would expect to remediate the issue and provide the board a description of the event at the following meeting. Alerting the board with a prompt notification would draw attention to a topic that does not reflect immediate concern and should be reserved for more pressing matters. Thus, we recommend that the final rule not require prompt reporting on topics that "could have materially affected" the fair value process, recognizing that such topics would be addressed in the periodic board reporting on the operation and effectiveness of the program.

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JPMAM appreciates the opportunity to comment on the Commission's proposed rule. We would be pleased to provide any further information or respond to any questions that the Commission or the staff may have.

Very truly yours,  
/s/ Brian S. Shlissel  
Brian S. Shlissel  
Managing Director  
Chair, Americas Valuation Committee

Cc: The Honorable Jay Clayton, Chairman  
The Honorable Hester M. Peirce, Commissioner  
The Honorable Elad L. Roisman, Commissioner  
The Honorable Allison H. Lee, Commissioner  
Dalia Blass, Director, Division of Investment Management