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July 21, 2020

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Good Faith Determinations of Fair Value, Investment Company Act Release No. 33845 (April 21, 2020): File No. S7-07-20

Dear Ms. Countryman:

This letter is submitted by the Committee on Investment Management Regulation of the New York City Bar Association (the "Committee") and responds to the request of the Securities and Exchange Commission (the "Commission") for comment set out in Investment Company Act Release No. 33845 (April 21, 2020) (the "Release"). The Committee is composed of lawyers with diverse perspectives on investment management issues, including attorneys from law firms and in-house counsel to financial services firms, investment company complexes and investment advisers.

In the Release, the Commission has proposed Rule 2a-5 (the "Proposed Rule") under the Investment Company Act of 1940, as amended (the "Act"), to provide requirements for determining the fair value of investments by investment companies registered under, and business development companies subject to, the Act (each, a "fund," and collectively, "funds"), including proposed requirements for boards of directors/trustees ("boards") of such funds to follow in order to meet their obligation of exercising "good faith" in carrying out their responsibilities for fair valuation. Section 2(a)(41) of the Act ("Section 2(a)(41)")

defines the term "value" with respect to assets of funds[1] to include, for securities and assets for which market quotations are not readily available, the "fair value as determined in good faith by the board of directors" of such securities or assets.

As the Commission notes in the Release, in the 80 years since the Act was adopted, the types and numbers of securities for which market quotations are not readily available, whether because of the nature of the securities, the manner in which they are traded, or the increase in the occurrence of anomalous or transient market conditions, have increased significantly, and the techniques that are used for estimating value have also been developed and refined substantially. We agree that, in light of those developments, it is entirely reasonable and appropriate for the Commission to provide greater guidance on what it views as the circumstances that would demonstrate a board's exercise of "good faith" through diligent oversight in carrying out fair valuation responsibilities. In essence, the Commission's statements in the Release and the structure of the Proposed Rule amply demonstrate the Commission's views that boards should consider improvements in valuation techniques that have evolved since 1940 or since Rule 2a-4 under the Act was adopted in 1964, or since the Commission adopted Accounting Series Release 113 ("ASR 113") in 1969 and Accounting Series Release 118 ("ASR 118") in 1970.

This letter expresses the view that certain aspects of the Proposed Rule could benefit from clarification or, in some cases, reconsideration. The Committee submits this letter to highlight those aspects of the Proposed Rule and to respond to certain questions asked by the Commission in the Release.

1. Board Oversight and Good Faith Responsibilities Are Fiduciary Responsibilities under State Law and the Proposed Rule Can Be Seen as Circumscribing a Board's Exercise of Good Faith under Applicable State Law Affecting the Duties of Directors as Fiduciaries.

The Committee fully supports the Commission's goal of updating and modernizing its expectations as to practices for determining fair value for purposes of Section 2(a)(41) and stating its views as to how boards can demonstrate their exercise of good faith in overseeing the implementation of fair valuation procedures. The Committee nevertheless has concerns that the Commission may have crossed into the area of articulating principles of fiduciary responsibility, which – in the context of board duties – are exclusively governed by state law. We note that Section 2(a)(41) is a definitional provision of the Act, one purpose of which was to provide boards with latitude in determining the fair value of securities and other assets held by funds for which market quotations are not readily available. The value of such securities and assets is defined to be whatever the board determines, so long as such determinations are made in "good faith."[2]

Notably, Section 2(a)(41) does not define the term "good faith" nor does the use of the phrase suggest that Congress intended to set out (in the definition of "value," an entirely different term) a federal fiduciary duty separate from the state common law equitable principle – or statutory codification – bound up in the concept of a board's fiduciary duty.[3] In that light, we submit that, to the extent that the Proposed

[1] Under Section 2(a)(41), the term "value" is, in pertinent part, defined as follows: "with respect to assets of registered investment companies, . . . [value] means— . . . (B) . . . (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors; in each case as of such time or times as determined pursuant to this title, and the rules and regulations issued by the Commission hereunder." Rule 2a-4(a)(1) further defines the term "current net asset value" of redeemable securities of registered funds used in computing periodically the current price of those securities for the purpose of distribution, redemption, and repurchase, and states in pertinent part that that such determination shall be made as follows: "(1) Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company."

[2] *See* the Commission's statement in the Release at p. 20 that "[w]e recognize, however, that there is no single methodology for determining the fair value of an investment because fair value depends on the facts and circumstance of each investment, including the relevant market and market participants (footnote omitted)."

[3] *See* discussion, *infra*, of *In re* Walt Disney Co. Derivatives Litigation, 907 A.2d 693 (Del. Ch. 2005).

Rule is intended to provide requirements, not merely guidance, for purposes of determining fair value under Section 2(a)(41) of the Act and Rule 2a-4 thereunder, the final rule should not establish a list of elements for the evaluation of a board's exercise of good faith. An evaluation of whether a board has exercised good faith in considering a matter requires consideration of the entirety of a board's attention to the matter under the rubric of state law fiduciary principles – not a one-size-fits-all list.

The Release states that "[t]he [P]roposed [R]ule would provide *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"[4] in the form of a list of elements and "to determine the fair value of fund investments in good faith requires a certain minimum, consistent framework for fair value and standard of baseline practices across funds, which would be established by the proposed rule."[5]

Under the Proposed Rule, the standard of baseline practices – which appear to be a proxy for "good faith" – would be established as specific regulatory requirements. Those requirements include:

- assessing and managing material risks associated with fair value determinations,
- selecting, applying and testing fair value methodologies,
- overseeing and evaluating any pricing services used,
- adopting and implementing policies and procedures, and
- maintaining certain records.

We urge that, instead of expressing those practices as requirements that a board must meet to demonstrate its "good faith," the Commission take an approach similar to that it used in its adoption of other rules under the Act, namely setting out factors for a board to consider, not in the rule itself, but in the Commission's commentary in the proposing and adopting releases for that rule,[6] and explicitly recognizing that the board has authority to decide what factors, including those suggested, are most relevant to consider.[7] Section 15(c) of the Act – which deals with one of the most important fiduciary obligations of a board, approving or renewing an investment advisory agreement – takes a similar approach and does not set out the specific factors a board must consider in taking such action, but rather describes the *process* that must be followed.

As stated above, the concept of "good faith" as used in Section 2(a)(41) under the Act is not otherwise defined or explained in that provision (or in other federal securities laws in which the term is used).[8] Instead, the duty of good faith on the part of corporate directors is derived from equitable principles applied to the responsibilities of directors under state law, which applies also to fund boards since most funds are organized under state corporate or business trust laws.[9] The duty of "good faith" on the part of

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[4] Release at p. 14 (emphasis added).

[5] *Id*. at pp. 14-15.

[6] For example, *see* the releases proposing and adopting Rule 12b-1, Releases Nos. IC-10862 (Sep. 7, 1979) and IC-11414 (Oct. 28, 1980). Rule 12b-1 specifies a process by which a board may meet its fiduciary duties in approving a 12b-1 plan for a fund but lets the board decide what factors are relevant to consider in adopting such a plan.

[7] The Commission followed a similar approach in adopting Rule 38a-1 under the Act, stating in its release accompanying the adoption of that rule the process by which a fund board should exercise its responsibilities, rather than in the text of the rule itself. "Compliance Programs of Investment Companies and Investment Advisers," Release No. IC-26299 (Dec. 17, 2003) ("Compliance Rules Adopting Release") (text accompanying note 34).

[8] *See, e.g.*, Section 20(a) of the Securities Exchange Act of 1934 (providing an exception to the "control person" liability provisions in that section if the controlling person acted in "good faith" and otherwise did not act to cause the underlying violation).

[9] "When the 1940 Acts do not apply to a particular issue, state laws apply. As in other situations, state laws are the residual laws. In addition, the [U.S.] Constitution limits the reach of federal laws." T. Frankel, Investment Management Regulation, 4th Ed. (Fathom Publ. Co.). In determining whether Congress intended to supersede state law in drafting a statute, the assumption is that "the historic police powers of the States were not to be superseded by

directors of Delaware corporations, for example, is a matter of continual development and interpretation by the courts. A commentator summarized the current understanding as follows:

> The duty of loyalty includes a director's obligation to act in good faith. Although the duty of good faith was once considered a free-standing duty under Delaware law, more recent decisions treat the concept of good faith as a part of the duty of loyalty. A director violates the duty of good faith when that director intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.[10]

To define, for statutory purposes, as the Commission appears to do in the Proposed Rule, the activities on the part of fund directors/trustees, acting in their corporate capacity, that encompass "good faith" seems inconsistent with the way the term has long been interpreted under common law. It seems to us that to define the term in that manner is inconsistent with the way Congress would have intended that term to have been used in the Act. "Good faith," we believe, should be interpreted in accordance with the long-recognized canon of imputed common law meaning.[11] "Good faith," as used at common law, was well summarized by Judge Chandler in a significant Delaware Chancery Court case:

> To act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation. . . . To create a definitive and categorical definition of the universe of acts that would constitute bad faith would be difficult, if not impossible. And it would misconceive how, in my judgment, the concept of good faith operates in our common law of corporations. Fundamentally, the duties traditionally analyzed as belonging to corporate fiduciaries, loyalty and care, are but constituent elements of the overarching concepts of allegiance, devotion and faithfulness that must guide the conduct of every fiduciary.[12]

Judge Chandler's opinion goes on to describe a process to be followed by directors in carrying out their obligation of good faith, rather than detailing a list of specific actions to be taken. We believe that the Commission should adopt, endorse, or at least not interfere with, the state law principles of good faith, which require directors to maintain oversight through enforcement of procedural compliance with conscientious scrutiny for red flags.[13] Board members should not bear liability for undiscovered errors in

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[a federal law] unless that was the clear and manifest purpose of Congress." Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947).

[10] Wm. M. Lafferty, Lisa A. Schmidt, and Donald J. Wolfe, Jr., *A Brief Introduction to the Fiduciary Duties of Directors*, 116 Penn. State L. Rev. 320, 837 (2012) (footnotes omitted).

[11] "[W]here Congress borrows terms of art in which are accumulated the legal tradition and meaning of centuries of practice, it presumably knows and adopts the cluster of ideas that were attached to each borrowed word in the body of learning from which it was taken and the meaning its use will convey to the judicial mind." Morissette v. U. S., 342 U.S. 246, 263 (1952).

[12] *In re* Walt Disney Co. Derivatives Litigation, 907 A.2d 693, 755-756 (Del. Ch. 2005). Although we cite a Delaware case here, we note that other state courts, particularly in other states under which funds are most frequently formed, often follow Delaware common law. For example, "Maryland courts often look to Delaware law for guidance on issues of corporate law." Oliveira v. Sugarman, 130 A.3d 1085, 1093 n.10 (Md. Ct. Spec. App. 2016); and "[i]n corporate matters, Massachusetts courts will regularly look to opinions of the Delaware courts as courts 'with great experience in such matters.'" MAZ Partners LP v. Shear, No. 11-11049-PBS, 2016 WL 183519, at *5 (D. Mass. Jan. 14, 2016).

[13] *Cf.* Burks v. Lasker, 441 U.S. 471, 479 (1979) ("Burks"): "The [Investment Company Act] and [Investment Advisers Act] therefore, do not require that federal law displace state laws governing the powers of directors unless the state laws permit action prohibited by the Acts, or unless 'their application would be inconsistent with the federal policy underlying the cause of action' . . . ." citing Johnson v. Railway Express Agency, 421 U.S. 454, 465 (1975).

the creation, evaluation or fulfillment of fair value procedures unless heightened scrutiny was called for by warnings that a reasonable person would recognize.

2. The Ability of a Board to Assign Fair Valuation Responsibilities to an Investment Adviser under the Proposed Rule Should More Clearly Coordinate with a Board's Responsibilities under Rule 38a-1.

Subsection (b) of the Proposed Rule, specifying "Performance of Fair Valuations," states that "[t]he board may choose to assign the fair value determinations relating to any or all fund investments to an investment adviser of the fund, which would carry out all of the functions required in paragraph (a)(1) through (5) of this section; . . ." One of those requirements is "[a]dopting and implementing written policies and procedures addressing the determination of the fair value of fund investments." The Release continues, stating that "[w]here the board assigns fair value determinations to the adviser under proposed rule 2a-5(b), as discussed in section II.B., the fair value policies and procedures would be adopted and implemented by the adviser, subject to Board oversight under Rule 38a-1."[14]

The quoted statement suggests that when the board assigns the responsibility for fair valuation to the fund's investment adviser, the adviser can adopt the policies and procedures for "the fund." The suggestion appears to be directly at odds with the requirements of Rule 38a-1, which the Commission adopted in response to concerns about market timing and late-trading practices in the mutual fund industry.[15] Rule 38a-1(a) states, in pertinent part, that each registered investment company must, among other things, do the following:

> (2) Obtain the approval of the fund's board of directors, including a majority of directors who are not interested persons of the fund, of the fund's policies and procedures and those of each investment adviser, principal underwriter, administrator, and transfer agent of the fund, . . .

The Commission did not specify in Rule 38a-1 what those policies and procedures must contain,[16] but set out, in the release announcing the adoption of the rule, guidance about the necessity of a board process for adopting policies and procedures:

> We believe that funds that fail to fair value their portfolio securities . . . may violate rule 22c-1 under the Investment Company Act. Fund *directors* who countenance such practices fail to comply with their statutory valuation obligations and fail to fulfill their fiduciary obligation to protect fund shareholders. Accordingly, rule 38a-1 requires funds to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments [emphasis added, footnotes omitted].[17]

Thus, it is clear that in both the language of Rule 38a-1(a)(2) itself and in the release language cited above the Commission intended that a fund's board, and its non-interested directors (and not the fund's investment adviser), approve its valuation policies and procedures.

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[14] Release at p. 27.
[15] Compliance Rules Adopting Release, *supra* note 7 (at text accompanying nn. 43-47).
[16] As in the case of Rule 12b-1, discussed at n. 6, *supra.*
[17] Compliance Rules Adopting Release, *supra* note 7.

The Release, however, notes that "[w]here the board assigns fair value determination to the adviser . . . the fair valuation policies and procedures would be adopted and implemented by the adviser, subject to board oversight under Rule 38a-1."[18] That statement suggests that the board would have no role in "adopting" the policies and procedures and would merely exercise "oversight." But the Release later states that, "[t]o the extent that adviser policies and procedures under proposed rule 2a-5 would otherwise be duplicative of fund valuation policies under Rule 38a-1, a fund could adopt the rule 2a-5 policies and procedures of the adviser in fulfilling its 38a-1 obligations,"[19] presumably by doing so in accordance with subsection (a)(2) of Rule 38a-1. Furthermore, according to the Proposed Rule, "if the board of the fund does not assign the fair value determinations to an adviser to the fund, the *fund* must adopt and implement the policies and procedures required under paragraph (a)(5) (emphasis added)." The Committee submits that these statements appear to be inconsistent, and that under either approach, it is clearly the board's responsibility, not the investment adviser's, to adopt or approve the fund's valuation policies, whether designed by the fund board or the fund's investment adviser.

We also suggest that the Commission generally seek to coordinate better the language of the Proposed Rule with that of Rule 38a-1.

3. The Proposed Rule Should Clarify the Scope of the Board's Role of "Oversight."

In the Release, the Commission recognizes that, whatever the expectations were in the past about a board's role or capabilities with respect to fair valuation, most board members today would appear not to possess the experience or knowledge base to ascertain on their own the value of securities or other assets that a fund might own because of the inherent complexity of the structures of many of those securities and the mechanisms of how they are traded, including in private markets. In our collective experience, board members typically do not have mathematical or statistical expertise sufficient to ascertain appropriate valuation inputs, detect valuation or market anomalies, or analyze valuation models for complex securities. In addition, we believe the sheer number of securities that are required to be fair valued necessitates resort to automated systems such as those provided by pricing services. As funds and their investments have grown in complexity since the adoption of the Act, so has the disparity between the role of fund boards as understood when the Act was adopted in 1940 and their capabilities and responsibilities today.[20]

The Committee supports the Commission in describing the board's role as that of oversight, and in allowing the board to task the job of determining fair values to those professionals having better knowledge and expertise. In particular, the Committee supports the Commission's recognition of a board's ability to assign responsibility for fair value determinations to the investment adviser. The Committee believes that such responsibility is in many cases either already encompassed within a fund's investment advisory contract (unless that responsibility is disclaimed on the grounds that it is an obligation covered by a separate contract with an administrator or other service provider) or a duty pursuant to board-approved valuation procedures under Rule 38a-1.

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[18] Release at p. 27.

[19] *Id.* at p. 28.

[20] One commentator, who helped draft the Act, described what was contemplated in the Act with respect to the duties and responsibilities of fund boards: "Neither does the law require that the directors have any special or technical talent or expertise in the business of the company. They do not hold themselves out as having better judgment than that of a reasonably prudent man of affairs or as assuring that the results of their management will be successful or even satisfactory." A. Jaretzki, Jr., *Duties and Responsibilities of Directors of Mutual Funds*, 29 Law and Contemporary Problems 777 (1964) at 779 ("Jaretzki").

The Proposed Rule would formalize the board's ability to assign such function to the investment adviser, subject to board oversight. The Committee supports the Commission's recognition of the role of the investment adviser in the valuation process and its establishment of a rule that outlines standards for the adviser's performance. In that regard, the Committee believes that when the board assigns the fair valuation function to an investment adviser, the board's role should be identified as that of oversight. This comports with the understanding under state law of how the duty of good faith and the duty of loyalty are demonstrated, as stated above. The adviser's failure to fulfill the regulatory requirements of the Proposed Rule should not cause some higher standard for the board to spring (back) into effect. The Proposed Rule could be read to say that unless the board specifically assigns the tasks identified in the Proposed Rule (*e.g.*, record-keeping) to the investment adviser, and the investment adviser fulfills them, the board retains responsibility for each and every one of the tasks, since they are described in the Release as "requirements for determining fair value in good faith with respect to a fund for purposes of section 2(a)(41)."[21] Instead, the Commission could express the view, in the adopting release for the Proposed Rule, that a board, in the course of fulfilling its good faith oversight responsibilities, when it has assigned certain functions to the investment adviser, should at a minimum (i) review the reports required to be provided to it by the investment adviser under Rule 2a-5 (including reports to be provided within a specified period of time after an unusual event or recognition of a pricing failure) and (ii) determine whether additional corrective action should be undertaken, and by whom (including specialized consultants retained by the investment adviser or the board). Other activities left within the board's oversight role would be approving fund valuation compliance policies and procedures, as stated above, and assessing and managing conflicts of interest that the investment adviser has in determining fair values of a fund's securities. Those are "oversight" responsibilities that boards have become accustomed to carrying out, and such responsibilities do not by their nature require specialized skills or knowledge as to securities valuation.[22]

The Committee notes that the Release does not address the assignment of valuation functions by an internally managed fund, having no "investment adviser" to which to delegate these tasks. The nature of the requirements for a fair valuation program for such a fund is sufficiently complex and requires specialized skills that the fund's board of directors would not necessarily have. Under the final rule, the board of an internally managed fund should be able to delegate its responsibilities to an administrator or to the persons managing the fund's compliance oversight process, including the oversight of any pricing services that are used. The final rule should be expanded accordingly, not only for internally managed funds, but for all funds covered by the final rule.

The Committee recommends that the Commission set out its expectations as to the standards applicable to investment advisers with respect to valuation separately in Rule 2a-5 or as part of the adviser's compliance responsibilities under Rule 38a-1.[23] Rule 2a-5 could explicitly state that those requirements

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[21] Release at p. 14.

[22] As Jaretzki argued in 1964, "Within the area of its jurisdiction, the board of directors is responsible for control and general supervision of the business, for formulating its policies, and for establishing and maintaining an organization to implement these policies. This is a collective responsibility, imposed upon the directors as a board." Jaretzki at 779. Recent Delaware case law affirms exactly this principle. The Delaware Supreme Court stated in June 2019: "Under *Caremark* and this Court's opinion in *Stone v. Ritter*, directors have a duty "to exercise oversight" and to monitor the corporation's operational viability, legal compliance, and financial performance." Marchand v. Barnhill, 212 A.3d 805 (Del. 2019), citing *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996) and Stone v. Ritter, 911 A.2d 362 (Del. 2006).

[23] The Proposal states that in those cases in which the board determines the fair value of investments "the board-approved fair value policies and procedures would be adopted and implemented by the fund. Where the board assigns fair value determinations to the investment adviser under proposed rule 2a-5(b), . . . the fair value policies and procedures would be adopted and implemented by the adviser, subject to *board oversight* under rule 38a-1)." Release at p. 27 (emphasis added). The Committee believes that the adviser's responsibilities should remain the same, whether

include assessing and managing material risks associated with fair value determinations, or selecting, applying and testing fair value methodologies. Other requirements set out in the Release that are more prescriptive – in that they entail essentially day-to-day operational actions – such as appointing and overseeing pricing services that provide a feed of securities prices or evaluating prices on a day-to-day basis; providing particular reports to the board on a periodic or emergency basis; and maintaining records with respect to fair valuations, could be described as elements of the investment adviser's assigned responsibilities, or stated as examples of how Rule 2a-5's standards can be met.

The Committee believes in any case that the investment adviser (or the fund, in the case of internally-managed funds) should already be expected to maintain any and all records with respect to valuations as fund records under Section 31(a)(1) of the Act. The Committee sees no reason to list record-keeping as a separate requirement under the Proposed Rule, but instead the release accompanying the adoption of the rule should refer to the duty as a preexisting obligation.

Since board members are not required by the 1940 Act to have any particular type of expertise, to oversee the valuation function in good faith, they must be able to reasonably rely on the third parties they retain to prepare, evaluate, update and carry out such functions. The Commission should clearly acknowledge that it is reasonable and expected that a board will rely on the contributions of various third parties and that such reliance is an element of board oversight.

When adopting money market fund reforms in 2014, the Commission recognized the need for fund directors to rely on third parties.[24] As the Commission stated at the time: "the fund's board of directors may want to consider the inputs, methods, models, and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change" and "the fund's board of directors…[should] have a good faith basis for believing that the pricing service's pricing methodologies produce evaluated prices that reflect what the fund could reasonably expect to obtain for the securities."[25] Many fund directors expressed frustration at the time with these urgings by the Commission because there was no indication as to how non-expert directors could, among other things, evaluate complex mathematical models or themselves ascertain "what the fund could reasonably expect to obtain." One possible conclusion, although it was unstated in the release adopting the money market fund rules, was that the "good faith basis" should include reliance on the fund's service providers, including (when not evidently conflicted) the investment adviser, administrator, registered public accountants and outside counsel. The Committee urges the Commission, when examining the guidance for fund directors in the Release, to confirm that directors' good faith in carrying out their oversight responsibilities can be established by their reliance on such fund service providers.[26] Fund auditors must, at present, separately value each asset of the fund using a pricing service other than the fund or a proprietary

expressed as obligations under Rule 2a-5 or Rule 38a-1, and, as stated above, the board's oversight of valuation - beyond what Rule 38a-1 already requires – could be furnished in Commission guidance related to "good faith."

[24] Release Nos. 33-9616, IA-3879 and IC-31166 (July 23, 2014).

[25] *Id*. at p. 287.

[26] The Committee believes that it is especially important for the Commission to address this subject. In the past, Commission experts have denied that such reliance is appropriate – except, possibly, in the case of written opinions on specific questions. Former Commission Chairman Harvey Pitt, for example ("Expert Report of Harvey L. Pitt, Mar. 1, 2013, In the Matter of J. Kenneth Alderman *et al*., SEC Admin Proc. File No. 3-15127), stated in his "Expert Report" on behalf of the Commission in the Morgan Keegan proceeding, that "[h]ere, there can be no reliance on expert advice" (p. 62); "efforts to place reliance on [the auditors]. . . is unwarranted and misguided" because the auditors were not separately engaged to provide valuation guidance (p. 68); "Respondents cannot invoked [sic] an asserted reliance on counsel" because counsel's assistance was not in the form of an opinion (p. 72); and "The Board could not rely on . . . the Fund's CCO. . . since she. . . had no experience whatsoever with valuation" (p. 64). Without attempting to relitigate the Morgan Keegan matter, we submit that none of these positions was necessary for the proceeding, nor should they be adopted by the Commission in connection with Rule 2a-5.

methodology and report the valuation differences to the fund's audit committee, whether or not material. In our experience, counsel often assists in drafting, or suggests updates to, valuation procedures to reflect the ongoing search for best practices. The fund's chief compliance officer approves tests of the valuation process and confirms that the fund's investment team is not dictating prices to pricing services or engaging in activities that create conflicts.

Directors expect that the exercise of good faith includes the ability to rely on others with greater expertise, experience, day-to-day involvement with, and knowledge of, valuation matters. State law supports this principle. For example, in *City of Birmingham Ret. Sys. v. Good*, 177 A.3d 47, 59 (Del. 2017), the Delaware Supreme Court found that the "board 'exercised oversight' by receiving management presentations on the status of [regulatory] problems. The presentations identified issues . . . , but also informed the board of the actions taken to address the regulatory concerns." The Committee asks that the Commission not only confirm that boards may assign valuation responsibilities, but also make clear that boards may rely on the expertise of the persons to whom those responsibilities are assigned and those whom the board chooses to guide its oversight process.

4. The Committee Questions the Commission's View of the Role of Accounting Guidance in the Fair Valuation Process.

The Committee is concerned about the Proposed Rule's attempt to align aspects of the definition of "fair value" to the standards adopted by the accounting profession. We recognize that the Release made reference to only limited accounting standards – *i.e.*, guidance in Financial Accounting Standards Board ("FASB") Accounting Standard Codification Topic 820 – as to when market quotations are readily available. While we agree that U.S. generally accepted accounting principles can be helpful tools in the establishment of a fund's or an adviser's valuation process, we believe that the applicability of such principles should be limited for the reasons stated below.

As the Release notes, "[i]n contrast to the Investment Company Act, FASB Accounting Standard Codification Topic 820: Fair Value Measurement ('ASC Topic 820') uses the term 'fair value' to refer generally to the value of an asset or liability, *regardless of whether that value is based on readily available market quotations* or on other inputs."[27] The impetus for accounting standards in the area, originally established in Statement of Financial Accounting Standards No. 157, appears to have been to enable the adoption of mark-to-market accounting by types of users other than funds.

Nevertheless, the Release specifies that "[t]o be appropriate under the [Proposed] [R]ule, and in accordance with current accounting standards, a methodology used for purposes of determining fair value must be consistent with ASC Topic 820, and thus derived from one of [its] approaches."[28] The Committee is concerned that requiring reliance on evolving accounting literature can be problematic, as the most pressing issues addressed in that literature often are matters of consequence to users that are not bound to the principle of estimating what readily available market quotations would be in orderly markets. ASC Topic 820 places emphasis on approaches to fair valuation that relate to the process of producing audited financial statements, which, while important, are not rules or principles established by the Commission under the Act in connection with the calculation of fund's net asset value per share.

Furthermore, some fair valuation methodologies currently employed by funds (and their investment advisers) are not explicitly permitted by ASC Topic 820, such as the continual adjustment of the prices of foreign securities[29] held in a fund's portfolio. In this connection, the Release refers to paragraph

[27] Release at n. 13 (emphasis added).
[28] Release at p. 20.
[29] As the Commission is aware, pursuant to staff guidance, foreign securities held in a fund's portfolio after the close of trading in their principal foreign markets may be adjusted by a factor, such as the movement of prices in relevant

820-10-35-41C, which says that "[a] reporting entity shall *not* make an adjustment to a Level 1 input except in [certain specified] circumstances." The Release suggests that those circumstances include adjusting foreign security prices; however, clause b. of that paragraph of 820-10-35-41C speaks of "[w]hen a quoted price in an active market does not represent fair value at the measurement date [which] might be the case if, for example, significant events (*such as transactions in a principal-to-principal market, trades in a brokered market, or announcements*) take place after the close of a market but before the measurement date (emphasis added)." None of the mentioned examples contemplate the practice of adjusting Level 1 inputs based on the movement of other markets, as performed by mutual funds attempting to deal with problematic market-timing practices at odds with the interests of fund shareholders.

The generally accepted accounting principles identified in ASC Topic 820 are, in essence, outside the provisions of the Act that govern the operation of investment companies and the responsibilities of their boards of directors or trustees. The statement in the Release that "a methodology used for purposes of determining fair value must be consistent with ASC Topic 820" appears to require the application of a set of standards that is not subject to the Commission's oversight and adoption, and thus arguably represents delegation of aspects of fair valuation to the FASB and to the fund's accountants. Moreover, it seems to impose upon boards and other monitors of a fund's pricing policies a level of knowledge of accounting rules that is well outside the scope of their responsibilities. In addition, the Release does not address how a fund that seeks to adopt enhanced methodologies could be deemed to comply with generally accepted accounting principles if such practices are not yet reflected in formal accounting guidance or when new accounting rules within ASC Topic 820 are adopted but phased in over time.

The Committee is not convinced that valuation methods intended to guide the careful establishment of year-end values over the course of a full audit can be anything more than analogous to procedures appropriate for daily net asset value calculations by funds. Differences in valuations based on the application of different valuation methodologies should not expose funds and boards to any greater threat of liability than currently exists. Accounting literature can be recommended for review by advisers and boards in creating valuation policies and procedures, but we submit that the Proposed Rule should not require adherence to such literature.

The Committee believes that a better approach than incorporating accounting literature would be for the Commission to reissue and update ASRs 113 and 118, rather than withdraw them as proposed. ASRs 113 and 118 were designed for the particular legal and operational needs of registered investment companies and provide a framework for aspects of determining the fair value of certain securities and other assets of registered investment companies. For many years, they have represented Commission-adopted generally accepted accounting principles for funds. The Committee believes that ASRs 113 and 118, with revision, could continue to provide useful guidance to funds in determining fair value of certain securities and other investments, as opposed to the principles enunciated by FASB in ASC Topic 820, which are intended for use by operating companies as well as funds and are more generalized in their approach than ASRs 113 and 118.

5. The Committee Believes the Proposed Rule's Requirement as to the Application of a Consistent Methodology Should Be Clarified.

securities indices, to reflect changes in value that occur after the close of the foreign securities market but before the fund's net asset value is struck on a particular business day. *See* Putnam Growth Fund and Putnam Int'l Equities Fund, Inc. SEC Staff No-Action Letter (Feb. 23, 1981), which the Commission proposes to rescind; *see also* Compliance Rules Adopting Release, note 7, *supra*.

The Committee believes that the requirement in Proposed Rule 2a-5(a)(2)(i) to apply an appropriate fair value methodology in a consistent manner should not be interpreted to mean that a board must apply the same fair value methodology for a particular security held by each separate fund over which the board has responsibility or that a board cannot change that methodology for a particular fund. The Release instead suggests that methodological consistency is to be applied to entire asset classes. The Committee believes that boards should be advised of the differences in the methodologies being applied – and the advantages and disadvantages of differing approaches, as formulated in other clauses of subsection (5) of the Proposed Rule – but that precision as to the anticipated current market value of individual holdings should prevail over the accounting virtue of consistency (*i.e.*, to support fair comparison of financial statements).

The Commission recognizes that "there is no single methodology for determining the fair value of an investment because fair value depends on the facts and circumstance of each investment, including the relevant market and market participants."[30] The Release also appropriately recognizes that "there can be circumstances where it is appropriate to adjust methodologies if the adjustments would result in a measurement that is equally or more representative of fair value" and "the proposed rule's requirement to apply fair value methodologies in a consistent manner would not preclude the board or adviser from changing the methodology for an investment in such circumstances."[31]

The Release reflects the practice that different advisers and/or sub-advisers may be assigned the role of determining fair valuations and recognizes that each may have different views on the fair value of a fund investment. According to the Release, "a multi-manager fund could have multiple advisers assigned the role of determining fair value of the different investments that those advisers manage"[32] and "[t]he proposed rule would permit boards to assign the determination of fair value in good faith to the fund's primary investment adviser or one or more sub-advisers."[33]

The Release does not define "asset class," but does identify private equity investments as an example.[34] Members of the Committee are aware that, as a matter of current practice,[35] advisers or sub-advisers have recommended, and fund boards have adopted, different fair valuation methodologies with respect to different private equity investments within a fund, at the recommendation of third-party valuation experts. Valuation experts may, depending on the nature of an issuer, its competitors and the market in which it operates, among other factors, propose a valuation based on a weighted average of estimates computed by various methodologies.

We submit that an undue emphasis on consistency may unnecessarily hamstring boards in carrying out their fair valuation responsibilities. A board should be free to accept as appropriate the calculation that each adviser and/or sub-adviser will be using for its other accounts, and to implement a single or blended approach incorporating one or more methodologies of the adviser(s) and/or sub-adviser(s), as the case may be. Otherwise, boards and advisers will be challenged to "address reconciling differing opinions on the same investment (if applicable) and establishing clear reporting structures," as suggested in the Release,[36] without any clear internal valuation capability surpassing that of the experts on which different advisers and/or sub-advisers rely. A lead investment adviser should be expected to understand – and explain to the fund board – the differences in fair values estimated for a fund's positions, and to make a recommendation,

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[30] Release at p. 20.
[31] Release at p. 52.
[32] Release at p. 34.
[33] Question 22, Release at p. 39.
[34] Release, n. 45 at p. 19.
[35] The Proposed Rule is intended, according to the Release, to "reflect [the Commission's] understanding of current practices used by funds to fair value their investments." Release at p. 15.
[36] Release, n. 83 at p. 34.

if it has a view, as to which estimate is most appropriate, but not to enforce consistency for its own sake. The processes of testing under various market conditions over time should be allowed to provide guidance on the efficacy of the process.

An undue emphasis on consistency may limit the expertise on which a board and/or adviser may rely and ultimately undermine a board's good faith determinations, all for the sake of uniformity. The same is the case by a requirement for "reconciling differing opinions on the same investment (if applicable) and establishing clear reporting structures," as suggested by the Release.[37]

For the reasons noted above, the Commission should narrow, deemphasize or eliminate the focus in the Release on methodological consistency across asset classes, funds or boards[38] and limit any requirement for consistency to applying valuations to each individual security in the portfolio managed by each adviser or sub-adviser, unless and until changed to reflect a greater degree of conformity to expected market value.

6. The Timing of Required Prompt Board Reporting between Periodic Reports Should Be Expanded beyond Three Days, Especially for Non-Urgent Developments.

Proposed Rule 2a-5(b)(1)(ii) would require "prompt" board reporting for matters associated with an adviser's fair valuation process that materially affect or could have materially affected the fair value of the fund's portfolio for which the adviser has fair value responsibilities. These issues include significant deficiencies or material weakness in the design or implementation of the adviser's fair value determination process or material changes in the fund's valuation risks determined under Proposed Rule 2a-5(a)(1). "Promptly" for this purpose means no later than three business days under the Proposed Rule, but the Release clarifies that this may be extended for three business days if the materiality of the event is unclear at the time the event occurs. The Release notes that this prompt reporting is required prior to the adviser's next periodic report required under Proposed Rule 2a-5(b)(1)(i) because of the board's oversight role and that "there may arise an issue of such importance that requires prompt board attention."[39]

The source for the three-business-day deadline for prompt reporting is not clear from the Release and appears to the Committee not to be necessary for a board to properly exercise oversight with respect to an adviser's assigned valuation responsibilities. In explaining this requirement, the Release cites to certain definitions contained in Public Company Accounting Oversight Board Accounting Standard 2201 (which generally describes the standard that applies when an auditor is engaged to perform an audit of management's internal control over financial reporting) and Section 302(a)(5) of the Sarbanes-Oxley Act of 2002 (which requires the Commission to implement regulations requiring the relevant officers of an issuer to certify that they have disclosed significant internal control deficiencies to the issuer's auditors and the audit committee of the board of directors).[40] Neither of these sources appears to reference a requirement regarding reporting within a three-business-day period to an issuer's audit committee.

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[37] *Id.*

[38] As an example of the difficulties created by the concept of consistency, the Commission staff has stated that "a board could not arrive at different fair valuations for identical securities held by two or more funds that the board oversees, consistent with its good faith obligation." Div. of Inv. Mgmt. Letter to Investment Company Institute (Dec. 8, 1999) at n. 16 and accompanying text. However, administrative proceedings such as Pacific Investment Management LLC, Release No. IC-32376 (Dec. 1, 2016) have articulated circumstances in which a fund should adopt a fair valuation different from other funds in the same complex for identical securities.

[39] Release at p. 49.

[40] Release at p. 49, n. 115.

The Committee submits that the circumstances requiring prompt reporting by an adviser – apart from its regular periodic reporting to the board under its assigned fair valuation responsibilities – and the parameters of what constitutes "prompt" reporting should be defined in the valuation procedures approved by the board rather than prescribed in the circumstances noted in Proposed Rule 2a-5(b)(1)(ii). Issues that materially affect, or could materially affect, fair valuations may be more complex than situations in which the adviser is reporting a breach of an existing process or is providing a recommendation among limited alternatives.[41] Whether reporting is "prompt" in this context should depend upon the matter and what the board is being asked to do. If the adviser is simply informing the board of an error in the implementation of fair valuation procedures that was previously approved by the board or the matter involves a risk of material effects on the valuation of the fund's portfolio,[42] "prompt" reporting may reasonably occur within a shorter timeframe.

A board's performing an effective oversight role in a situation that requires revisions to a fund's fair valuation procedures, such as changes to a fair value methodology that applies to an investment, may necessitate an explanation and recommendation from the adviser. Doing so may take longer than three business days, particularly in a case in which new Commission staff or FASB guidance has been proposed or adopted or a pricing service is developing or testing new fair value methodologies and these matters were not covered in the adviser's previous quarterly report. Those developments may materially affect the portion of the fund's portfolio over which the adviser has valuation responsibilities, once implemented, but the effect is delayed or within the board's control.

To address these concerns, the Committee recommends that the parameters for what is considered to be "prompt" reporting be expanded beyond three days, especially for non-urgent developments, such as the recommendation or adoption of new Commission, Commission staff or FASB guidance or a third party's development and testing of new methodologies that occur after the adviser's last quarterly report. The amount of time would vary, depending on the situation, but could be longer for non-urgent matters (which would include items that would not have an immediate material effect on the valuation of the fund's portfolio).

Further, the Committee believes that the Proposed Rule's use of the terms "materially affect" or "could have materially affected" suggests that matters that would have a material effect on the fair value of investments assigned to the adviser in the future would not be within the scope of the adviser's prompt reporting requirement. The Committee requests that, if that interpretation is correct and developments such as proposed or newly applicable Commission or FASB guidance that does not have an immediate material effect on the fair value of investments whose valuation is assigned to the adviser would not need to be promptly reported, the Commission clarify this point in the final rule or accompanying release.

7. A Fund's Board Should Be Able to Rely on the Fund's Chief Compliance Officer and Investment Adviser to Identify Certain Conflicts of Interest that Need to Be Addressed under Rule 2a-5.

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[41] *Cf. Investment Company Liquidity Risk Management Programs Frequently Asked Questions: Answer to Question 32* (stating that, for reportable events to the board regarding when a fund exceeds the 15% limitation on illiquid investments and any applicable highly liquid investment minimum, "the staff believes that this verification and final determination process [to determine whether a limit was in fact breached] should be completed within three business days or less, including the day that the triggering event was observed"), *available at* https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq.

[42] *See* Heartland Advisors, Inc., *et al.*, SEC Rel. No. IC-28136 (Jan. 25, 2008) (imposing sanctions on an adviser and its principals for, among other things, improperly valuing securities, which partially resulted from a failure to effectively communicate information about the pricing of certain bonds).

Material conflicts of interest are one of the valuation risks that would be required to be managed under the Proposed Rule. The Release notes – in the context of discussing the board's oversight obligations in the event valuation responsibilities are assigned to the adviser – that "consistent with their obligations under the Act and as fiduciaries, boards should seek to identify potential conflicts of interest, monitor such conflicts, and take reasonable steps to manage such conflicts."[43] While awareness and management of conflicts of interest have been recognized as essential board functions,[44] requiring the board to "seek to identify potential conflicts of interest" implies, in the Committee's view, an investigative responsibility that departs from prior Commission and Commission staff interpretations of the board's role.

In the adopting release amending various exemptive rules to incorporate references to Rule 0-1(a) under the Act (which is cited by the Release as support for statements regarding the board's oversight role) (the "Governance Release"), the Commission's discussion about the role of independent directors focused on qualitative aspects of that role.[45] The Governance Release emphasized, for example, the importance of independence and objectivity for independent directors in overseeing the adviser's management of a fund with respect to "evaluation of management and its plans and proposals" and indicated that the interest of fund investors should be the objective behind independent directors' decision-making.[46] While such statements imply a more assertive role for independent directors, they do not seem intended to impose specific substantive obligations.

Furthermore, as the Commission staff noted in a recent no-action letter to the Independent Directors Council ("IDC No-Action Letter"), "the number and scope of director responsibilities have grown significantly as a result of market, regulatory and technological developments" and acknowledged that these responsibilities may detract from the board's ability to provide appropriate oversight over conflicts of interest concerns.[47] Under the IDC No-Action Letter, because the essential function of the fund's chief compliance officer ("CCO") is in part to seek to ensure that procedures are appropriately designed and are being followed, a board can rely on a certification from a fund's CCO regarding the fund's transactions in compliance with Rules 10f-3, 17a-7 or 17e-1 under the Act to enable the directors to focus on safeguarding the best interest of the fund and its shareholders. This approach is consistent with the structure and purpose of Rule 38a-1, which requires a fund to "designate one individual [*i.e.*, the CCO] responsible for administering the fund's compliance policies and procedures," which include policies and procedures involving matters with significant conflicts of interest concerns (such as identification of affiliates and affiliated transaction rules).

We agree that material conflicts of interest with respect to assessing and managing valuation risk should be identified to the board, but we believe that the fund's CCO and investment adviser are in a better position to identify and disclose conflicts that may not be reasonably apparent from information available to the directors, who typically lack the expertise and experience possessed by those involved in assigning fair valuations or administering fair valuation policies and procedures. Indeed, the fund's adviser is obligated under the Investment Advisers Act of 1940 to eliminate or make full and fair disclosure of all conflicts of interest that might incline the adviser to render advice that is not disinterested.[48] We believe, consistent with the approach in the IDC No-Action Letter, that the Commission should clarify in the final rule or release accompanying the adoption of the rule that the board can rely on the fund's CCO and investment adviser to identify conflicts of interest that should be addressed under Rule 2a-5.

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[43] Proposed Rule 2a-5(a)(1); Release at pp. 35–36.
[44] *See* Burks 441 U.S., at 482
[45] *Investment Company Governance*, Release No. IC-26520 (July 27, 2004) at Section II.
[46] Governance Release, *supra*, at n. 45 (internal quotation marks omitted).
[47] *See* Independent Directors Council, SEC Staff No-Action Letter (Oct. 12, 2018).
[48] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019).

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The Committee appreciates the opportunity to comment on the Proposed Rule. If we can be of any further assistance in this regard, please call me at (212) 728-8293.

Respectfully,

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