American Bankers Association
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Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Rule: Good Faith Determinations of Fair Value (File Number S7-07-20)

Ladies and Gentlemen:

The American Bankers Association[1] (ABA) appreciates the opportunity to provide comments to the Securities and Exchange Commission (SEC) on a proposed regulation (Proposed Rule 2a-5 or Proposal) that would provide requirements for determining fair value in good faith with respect to a registered investment company or business development company ("fund") for purposes of section 2(a)(41) of the Investment Company Act of 1940, as amended (Investment Company Act).[2] This determination would involve (i) assessing and managing material risks associated with fair value determinations, (ii) selecting, applying, and testing fair value methodologies, (iii) supervising and evaluating any pricing services that are used, (iv) adopting and implementing policies and procedures, and (v) maintaining certain records. Proposed Rule 2a-5 further would authorize a fund's board of directors to assign, or delegate, the fair value determination to an investment adviser (adviser) of the fund, which would then carry out one or more of these functions, subject to board oversight and reporting obligations.

Our membership includes banks that advise these funds, and therefore, would be directly impacted by the Proposal. Moreover, collective investment funds (CIFs) that are sponsored, advised, managed, and priced by a number of our bank members may invest in registered investment companies subject to the Proposal.[3] Since the Proposal, if finalized, would be the first federal agency rule governing fair value determinations and responsibilities, we further believe that other federal agencies would look to the Proposed Rule 2a-5 as an authoritative source in contemplating or preparing regulatory and/or supervisory guidance on fair value determinations and fair valuation practices. The Office of the Comptroller of the Currency (OCC), for example, looks to SEC Rule 2a-7 (governing money market funds) for guidance when determining appropriate regulatory requirements for the valuation of short-term investment

[1] The American Bankers Association is the voice of the nation's $20.3 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $15.8 trillion in deposits, and extend nearly $11 trillion in loans. Learn more at www.aba.com.
[2] *See* SEC, Good Faith Determinations of Fair Value, 85 *Fed. Reg.* 28,734 (2020).
[3] Collective investment funds are separate and distinct from registered investment companies and are supervised and examined under federal banking regulation. *See* 12 C.F.R. § 9.18 (2020) (OCC regulation).

funds (STIFs), which are sponsored, advised, and managed by national banks.[4] The Department of Labor (DOL) informally consults with SEC staff when considering issues that include the fair value determinations of retirement plan assets.[5]

We commend the SEC for updating and formalizing its supervisory guidance on fair value determinations. We believe Proposed Rule 2a-5 would provide clarity and transparency and would assist affected institutions on regulatory expectations regarding good-faith fair value determinations. The Proposal further represents an important recognition of current industry practices, including the critical role of advisers in the fair value determination process. In particular, the Proposal would alert banks serving as fund advisers and sub-advisers on the parameters of their responsibilities on fair valuation activity while allowing for some flexibility for fund board's and advisers to implement the specifics of delegated fair valuation responsibilities, depending on the nature and mix of fund investments. Guidance in the form of an SEC regulation also would provide elevated recognition to the necessity and importance of fair value practices in both institutional and retail investing. We therefore support adoption of the Proposal, with recommendations for additional modifications as described below.

I. The Proposal.

Fair value plays a fundamental role in portfolio investing. Proper valuation of investments, among other things, promotes the purchase and sale of fund shares at fair prices and protects against dilution of shareholder interests and the diminution of investment values and performance.[6] Improper valuation, on the other hand, "can cause investors to pay fees that are too high or to base their investment decisions on inaccurate information."[7] In the preamble to the Proposal (preamble), the SEC states that "regulatory developments have significantly altered the framework in which funds, boards, fund investment advisers, other fund service providers such as pricing services, and auditors perform various functions relating to fair value determinations."[8] Moreover, fair value determinations routinely require, and are reliant on, the expertise, experience, and resources that often are provided by fund advisers and service providers operating in the US and internationally. The Proposal therefore is a welcome and timely initiative that will facilitate the alignment of regulatory expectations with industry standards and practices.

We believe that Proposed Rule 2a-5 will support and strengthen the financial services industry's commitment to providing fair value determinations made in good faith. The following details our comments to the various sections of the Proposal, which are focused primarily on accounting and adviser-related issues. We also suggest additional improvements and refinements that would increase the regulatory functionality and compliance certainty, consistent with the SEC's goals

[4] *See* 12 C.F.R. § 9.18(b)(3)(iii) (OCC requirements regarding method of valuation for STIFs).
[5] *See, e.g.,* DOL Information Letter (June 3, 2020) n.1 (DOL coordinated with SEC Chairman in considering request on the use of private equity investments in designated investment alternatives of retirement plan, which included discussion of fair value issues raised by private equity investing).
[6] 85 *Fed. Reg. at* 28,735.
[7] *Id.*
[8] *Id. at* 28,737.

of establishing a "consistent framework for fair value and standard of baseline practices across funds."[9]

II. Accounting Issues.

A. Do not expressly tie the Proposal to GAAP concepts since this could expose Proposed Rule 2a-5 to changes without the benefit of the public comment process.

Proposed Rule 2a-5 appears designed to track the concepts of Generally Accepted Accounting Principles (GAAP), although it does not expressly incorporate specific GAAP standards or language. The financial services industry has successfully applied GAAP on valuation (*e.g.*, Accounting Standards Codification (ASC) Topic 820 on Fair Value Measurement) and we support the SEC's objective of ensuring that the Proposal is consistent with GAAP. We recommend against creating fair value standards or requirements that would be in addition to, or diverge from, GAAP.

At the same time, we recognize the possible legal issues arising under the Administrative Procedures Act (APA) if GAAP standards or language were incorporated expressly into the Proposal. In such instance, it is possible that evolving interpretations of GAAP measurement practice, or related matters correspondingly would change the substance of Rule 2a-5 *without* the opportunity for public notice and comment, in violation of APA requirements.[10] We recommend therefore that the Proposal simply reference, rather than incorporate, GAAP principles, while giving the SEC the latitude (*i.e.*, reservation of authority) to interpret Rule 2a-5 to account for any future changes or modifications to GAAP that would or might impact the language or requirements of the SEC rule. Such a provision could read as follows:

> "*(e)* *Reservation of authority*. Nothing in this part limits the authority of the SEC to interpret this part consistent with Generally Accepted Accounting Principles (GAAP) and releases of the Financial Accounting Standards Board (FASB) governing fair value measurement and fair valuation practices."

B. In order to avoid confusion and/or uncertainty, either (i) delete the Proposal's definition of a "readily available" market quotation, or (ii) align the definition with FASB's definition of a "readily determinable" fair value of a security.

[9] *Id.*

[10] A potential change in practice, for example, may result from interpretations of necessary internal controls over "management bias," which is introduced by PCAOB Auditing Standard 2501, "Auditing Accounting Estimates, Including Fair Value Estimates (as Amended for FYE 12/15/20 and After)" (AS 2501). During times of market illiquidity, and especially related to hard-to-value assets, reliance on Level 3 fair value inputs are likely to increase. Controls over "availability bias," "anchoring bias," "confirmation bias," and "familiarity bias" already have been mentioned by the American Institute of CPAs Practice Aid related to AS 2501 and could change practices on how such inputs are considered without SEC oversight.

The Proposal includes a definition of when market quotations would be deemed readily available under the Investment Company Act. Specifically, Proposed Rule 2a-5 states that:

> "a market quotation is readily available only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable."[11]

In Question 52 of the Proposal, the SEC asks whether the definition of a "readily available market quotation" should *expressly* refer to [which we interpret to mean "incorporate"] GAAP "to ensure consistency with US GAAP in case of changes over time."[12] As noted above, we do not believe that it is necessary or advisable for the SEC to expressly refer to GAAP. Moreover, it is not clear that the SEC definition in the Proposal is consistent with the term, "readily determinable," under GAAP, or whether the SEC is intending to distinguish between the two terms. Our understanding is that under GAAP, the value of an equity security generally is "readily determinable" if its quotations are available on an SEC-registered exchange or comparable foreign market, or on an over-the-counter (OTC) market, if the OTC quotes are publicly reported.

Consequently, there appears to be a distinct difference between the Proposal's definition of "readily available" and the GAAP definition of "readily determinable." This would appear to result in certain securities possibly qualifying as "readily determinable" under GAAP while failing to qualify as "readily available" under Rule 2a-5.[13] The Proposal thus would appear to label (unnecessarily) the quotes of such securities as "not reliable," even though their value would be "readily determinable" under GAAP. If this is not the intended potential consequence of the SEC, we recommend that the SEC, rather than specifically define the term "readily available market quotation," either (i) delete the definition altogether, or (ii) state that market quotations are readily available as described in relevant GAAP and FASB standards consistently applied, and as interpreted from time to time by the SEC.

III. Adviser Fund Relationship Issues.

A. Clarify that a fund adviser may hire, retain, and delegate to one or more sub-advisers one or more fair valuation responsibilities, and may do so without the prior written approval of the board, or on a non-objection basis from the board.

The Proposal expressly provides that the board may assign the fair value determination of any and all fund investments to an adviser of the fund.[14] The SEC apparently has interpreted this provision to permit the board to assign a fair valuation role to one or more *sub-advisers*.[15] What is unclear is whether the board must directly make the assignment to a sub-adviser or whether the

[11] 85 *Fed. Reg. at* 28,770.
[12] *Id. at* 28,749.
[13] Specifically, it is possible that the value of a Level 2 security (*e.g.*, a corporate bond or interest rate swap) could be deemed "readily determinable" under GAAP and *not* "readily available" under the Proposal.
[14] 17 C.F.R. § 270.2a-5(b), 85 *Fed. Reg. at* 28,769.
[15] 85 *Fed. Reg. at* 28,744 (Question 22).

adviser independently may appoint one or more sub-advisers. This is an important distinction since advisers generally rely on sub-advisers whom they have selected to assist the adviser extensively with portfolio management, often in areas outside the adviser's expertise, such as in illiquid assets and foreign private equity.

We recommend that the SEC clarify in the Proposal that a board-appointed adviser may in turn select one or more sub-advisers to assist the adviser in discharging those fair valuation responsibilities that the board has assigned to the adviser. We recommend further that the adviser be permitted to hire and retain one or more of these sub-advisers without the prior written approval of the board, or alternatively, upon non-objection of the board after 30 days from receiving written notice from the adviser of the intended hiring and retention of the sub-adviser(s). This would provide the adviser with the flexibility and efficiency required to effectively satisfy its fair value obligations to the board, particularly given the vast range and diversity of investment objectives, demands, and options in today's fund portfolios.[16]

B. Clarify that a fund adviser reasonably may rely on the prices provided by one or more pricing services, provided that the adviser complies in good faith with those responsibilities described in Proposed Rule 2a-5 which are assigned to it by the board.

The Proposal provides that determining fair value in good faith requires a board to oversee third party pricing service providers, including the establishment of (a) the process for the approval, monitoring, and evaluation of each pricing service provider, and (b) the criteria for initiating price challenges (*e.g.*, establishing objective thresholds).[17] In doing so, the SEC states that the board should take into consideration factors such as (i) the qualifications, experience, and history of the pricing service, (ii) the valuation methods or techniques, inputs, and assumptions used by the pricing service for different classes of holdings, and how they are affected as market conditions change, (iii) the pricing services process for considering price "challenges," including how the pricing service incorporates information received from pricing challenges into its pricing information, (iv) the pricing service's potential conflicts of interest, and the steps the pricing service takes to mitigate such conflicts, and (v) the pricing service's testing processes.[18]

Although it describes the *process* for retaining a pricing service, Proposed Rule 2a-5 does not identify nor describe the bases upon which the board (or an adviser assigned with fair value responsibility) may *rely* on the prices provided by a pricing service. We believe that an adviser assigned fair value responsibility should be permitted to reasonably rely on the prices provided by a pricing service, provided that it complies with regulatory requirements (a) and (b) above and has satisfied itself on the considered factors (i) through (v) above. This is consistent with industry investment practices elsewhere (such as in ERISA section 103(a)(C)(3) audits)[19] and reflects the extraordinary challenges a single adviser would have to be solely responsible for

[16] We assume that the board would retain the authority to fire the adviser or sub-adviser(s) or otherwise relieve at any time the adviser and any sub-adviser of their respective fair valuation responsibilities.
[17] 17 C.F.R. § 270.2a-5(a)(4)(proposed), 85 *Fed. Reg. at* 28,769.
[18] 85 *Fed. Reg. at* 28,740.
[19] *See* 29 U.S.C. § 103(a)(C)(3) (statutory authority); 29 C.F.R. § 2520.103-8 (DOL implementing regulation). These were known formerly as "limited scope" audits.

pricing every investment in the fund. We recommend, therefore, that the SEC allow a board and adviser to reasonably rely on the prices obtained from a pricing service, provided that the board/adviser has complied in good faith with the regulatory requirements, including the initiation of pricing challenges where necessary or appropriate.

C. Where segregation between the process of making fair value determinations and the portfolio management cannot be made as a result of one or more conflicts of interest, allow the adviser to determine a reasonable alternative process to mitigate such conflict(s), such as (i) measuring fair value by applying the permissible practical expedient for investments measured at NAV, or (ii) establishing reasonable reconciliation procedures.

The Proposal provides that an adviser that is assigned fair valuation responsibilities must reasonably segregate the process of making fair value determinations from the portfolio management of the fund.[20] This requirement recognizes the potential conflicts of interest that are present in the fair value determination process involving the input that portfolio managers may have in the design or modification of fair value methodologies, or in the calculation of specific fair values. While the SEC acknowledges that it may be appropriate for portfolio managers to provide input into the process for determining the fair value of fund investments, these same individuals are also often compensated, at least in part, on the fund's performance. They may also be concerned about the value and reputation of the fund's performance track record, which can incent the portfolio manager to smooth returns or otherwise intentionally misvalue a fund's portfolio investments.[21] Thus, while the segregation requirement is not intended to prevent portfolio managers from providing inputs that are used in the fair value determination process, the SEC believes that a portfolio manager should not be making the fair value determinations.[22]

Nevertheless, the SEC has asked whether it should exempt smaller advisers from this requirement, in recognition that segregation might not structurally be possible with these advisers. The SEC further asks whether there are effective steps, other than segregation, that could be used to mitigate potential conflicts of interest involving portfolio management personnel.[23] There are instances in which certain investments, especially hard-to-value assets such as real estate and limited partnerships, are managed by a portfolio manager with insufficient personnel (or which is experiencing recent turnover in personnel) to reasonably segregate fair value determinations from portfolio management. Furthermore, it may not be feasible from a cost perspective to hire an independent pricing source to make the fair value determination of such investment. In such instances, we recommend that the SEC permit the adviser to devise a reasonable alternative process, such as (i) measuring fair value by applying the permissible practical expedient for investments measured at NAV,[24] and (ii) establishing reconciliation

[20] 17 C.F.R. § 270.2a-5(b)(1)(2) (proposed), 85 *Fed. Reg. at* 28,770.
[21] *See* 85 *Fed. Reg. at* 28,747.
[22] *See id.*
[23] *See id. at* 28,748 (Question 45).
[24] FASB's ASC Topic 820 allows reporting entities, as a practical expedient, to measure certain investments at their NAV per share (or equivalent). The practical expedient is allowed only if the following conditions are met as of the measurement date: (i) the investment does not have a readily determinable value, and (ii) the invested entity is an investment company within the scope of ASC Topic 946, Financial Services – Investment Companies.

procedures that are designed to protect against improper valuation of fund investments. This can be accomplished by adding the following language (in italics) to the text of the Proposal:

> "(2) *Specify responsibilities.* The adviser specifies the titles of the persons responsible for determining fair value of the assigned investments, including by specifying the particular functions for which they are responsible, and reasonably segregates the process of making fair value determinations from the portfolio management of the fund.
>
> "*Where the adviser reasonably determines that such segregation is not possible with respect to a particular fund investment, the adviser may establish one or more alternative processes for making fair value determinations, including but not limited to (i) measuring fair value by applying the permissible practical expedient for investments measured at NAV or by similar means as reasonably determined by the adviser, and (ii) establishing reconciliation procedures reasonably designed to protect against misvaluation of the fund investment. The adviser shall notify the board that such segregation is not possible, identify the conflicts of interest raised as a result, and report on the means used, and results achieved, by the use of one or more alternative processes for making fair value determinations.*"

IV. Adviser Reporting Issues.

A. Do not adopt an adviser attestation requirement. Adopt the Proposal as written, where the board is required to "oversee" the adviser without requiring an attestation.

As part of delegating the fair value determination to an adviser of the fund, the board is required to supervise the adviser.[25] The SEC asks in Question 25 of the preamble whether it should require the board, as part of its oversight responsibilities, to receive an attestation from the adviser, which presumably would certify that the adviser has complied with Rule 2a-5's responsibilities on fair valuation to which the adviser has been assigned.[26]

We do not believe that an attestation is required to ensure that the adviser is discharging its duties under assignment from the board. Moreover, an attestation would unnecessarily raise the expenses of retaining an adviser and could further reduce the number of available fund advisers and sub-advisers, due to the heightened liability exposure and costs associated with providing an attestation. We recommend, therefore, that the SEC refrain from adding an attestation requirement to the Proposal.[27]

[25] 17 C.F.R. § 270.2a-5(b)(1) (proposed), 85 *Fed. Reg. at* 28,770.
[26] *See* 85 *Fed. Reg. at* 28,744.
[27] If the SEC is seeking assurance on adviser compliance, this may be accomplished instead by contractual language that could provide similar assurance and protection to the fund board.

B. Do not require a minimum frequency for re-assessing valuation risk but provide flexibility for valuations as market conditions and circumstances warrant.

As part of risk management of fair valuation practices, the Proposal requires a periodic assessment of any material risks associated with the determination of the fair value of fund investments (valuation risk).[28] The SEC asks in Question 2 of the preamble whether it should require a minimum frequency for re-assessing valuation risk, such as for a market event or investment strategy change.

In light of the well-established market practice for registered investment funds of quarterly board reporting on valuation determinations, issues, and policies, we recommend that the SEC not require a minimum frequency for re-assessing valuation risk. Instead, the SEC should provide flexibility for determining the frequency of assessing valuation risk in accordance with established practices, as market conditions and circumstances warrant. With respect to a material change in an adviser's investment strategy, we recommend that the adviser report such change to the board within a reasonable time period after such change, in line with established industry practice, with the board itself retaining the option to require the adviser to re-assess the valuation risk as a result of such change by the next annual reporting date or before such date as designated by the board. We believe these modifications would balance the need for periodic assessment of valuation risk with the flexibility required to respond to changing market conditions and investment opportunities.

C. Extend the adviser's prompt reporting requirement to the fund board regarding any material impact on the fair value process or valuation risks from three business days to 10 business days, in order to give the adviser the necessary time to determine and verify whether the impact of the fair value matter is, or could be, material.

Proposed Rule 2a-5 includes a prompt reporting requirement, whereby an adviser must report promptly any matter (but no later than three business days after the adviser becomes aware of the matter) associated with the adviser's process that materially affects, or could have materially affected, the fair value of the assigned portfolio of investments.[29] This would include a "significant deficiency" 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.[30] In the preamble, the SEC asks whether it should allow different time frame, such as a longer time (10 business days) or shorter time (one business day) to report to the board.[31]
Although certain matters may enable the adviser to report to the board within a shorter time frame, there may be situations that would make it difficult or nearly impossible to meet the three-business day time limit. For instance, if the adviser's systems are down due to extended power outage from an unanticipated event (*e.g.*, cyberattack, wildfire), it may involve an extended time period before power is restored to allow the adviser to investigate the matter at hand. If the impact involves an internationally based sub-adviser, it may take up to several days before the

[28] 17 C.F.R. § 270.2a-5(a)(1) (proposed), 85 *Fed. Reg. at* 28,769.
[29] 17 C.F.R. § 270.2a-5(b)(1)(ii) (proposed), 85 *Fed. Reg. at* 28,770.
[30] *Id.*
[31] *See* 85 *Fed. Reg. at* 28,747 (Question 40).

adviser receives sufficient reporting of the incident necessary to launch the investigation into its material impact on fair value. We would not anticipate that an adviser would routinely or reflexively resort in every instance to the 10-business day time limit. On the other hand, the 10-business day period would assure an adviser that it would have adequate time, if necessary, to make the requisite investigation to determine whether an event materially impacts the fair value to which it has been assigned. We recommend, therefore, that the SEC allow up to 10 business days for the adviser to report such matters to the board.

V. Other Issues.

A. The Proposal should be finalized as a safe harbor in order to provide a non-exclusive means of achieving regulatory compliance with fair value determinations made in good faith.

Although the Proposal, if finalized, would be a principles-based regulation, there are a number of express requirements to satisfy in order to achieve compliance with determining fair value in good faith and with the establishment and implementation of fair valuation policies, procedures, and practices. The Proposal, moreover, does not appear to allow for flexibility to achieve compliance outside the intended regulatory framework, notwithstanding that implementation of a fair valuation program is not a "one-size-fits-all" exercise. Nevertheless, as the SEC has stated in a prior release, "[n]o single standard for determining 'fair value in good faith' can be laid down, since fair value depends on the circumstances of each individual case."[32]

We recommend, therefore, that the SEC finalize the Proposal as a safe harbor; that is, establish a non-exclusive means of achieving regulatory compliance with fair value determinations made in good faith. This would permit flexibility in meeting SEC regulatory expectations. It would further appropriately make allowance for those unintended instances of technical non-compliance with a particular fair value requirement that do not warrant an SEC sanction or enforcement action.[33]

B. Consultation recommendation: consult with accounting organizations and industry trade groups prior to finalizing the Proposal to confirm consistency with GAAP, applicable FASB and AICPA releases, and industry practices.

In the preamble, the SEC confirmed that its views on the Proposal were "informed by significant outreach that the [SEC] staff has conducted with funds, investment advisers, audit firms, trade groups, fund directors, and others, particularly over the past two years."[34] We commend the SEC for reaching out to these marketplace participants in the course of drafting the Proposal. We recommend that the SEC, prior to finalizing the Proposal, consult with these and other marketplace participants in order to confirm that a finalized Proposal would be consistent with

[32] *See* SEC, Accounting for Investment Securities by Registered Investment Companies, *Accounting Series Release No. 118* (Dec. 23, 1970). *Accord* Small Business Administration: Small Business Investment Companies, 58 *Fed. Reg.* 41,882, 41,897 (1993) (in laying out valuation guidelines for SBICs, SBA acknowledges that there is no single standard for determining fair value in good faith).

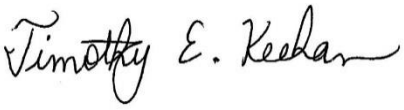
[33] Any such technical non-compliance, moreover, generally may be remedied with an appropriate cure period.

[34] *See id. at* 28,737.

GAAP, applicable FASB and AICPA releases, and industry practices. This would confirm the SEC's objectives and provide the opportunity to dialogue on the ways in which the Proposal could be refined further to improve the clarity and functionality of the regulatory requirements.

Thank you for your consideration of our views and recommendations. If you have any questions or require any additional information, please do not hesitate to contact the undersigned at 202-663-5479 (tkeehan@aba.com).

Sincerely,



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