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July 20, 2020

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

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

Dear Ms. Countryman:

This letter is submitted by the Federal Regulation of Securities Committee (the "**Committee**") of the Business Law Section (the "**Section**") of the American Bar Association (the "**ABA**"). It was drafted by the Committee's Task Force on Fund Directors, which comprises members of the Investment Companies and Investment Advisers Subcommittee of the Committee. The mission of the Task Force is to promote the best interests of investors by sharing its members' collective knowledge and experience representing independent directors and communicate with the Securities and Exchange Commission (the "**Commission**") and its staff about possible updates that might be made to the current regulation and guidance regarding the duties of fund directors.

The comments set forth in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and, therefore, do not represent the official position of the ABA. In addition, this letter does not represent the official position of the Section nor does it necessarily reflect the views of all members of the Committee.

The Committee commends the Commission's proposal of Rule 2a-5 (the "**Proposed Rule**") as a significant step forward in providing clarity regarding how fund boards of directors/trustees can fulfill their valuation responsibilities under the Investment Company Act of 1940, as amended (the "**1940 Act**"), in a way that recognizes current markets and practices and the board's traditional oversight role.

The Committee supports the Commission's efforts to provide boards and advisers with a consistent, modernized approach to fair value determinations, but agrees with many of the points in Commissioner Hester Peirce's statement issued in connection with the release of the Proposed Rule.[1]

1. In the statement, Commissioner Peirce stated that "[t]he proposing release acknowledges that 'few boards today are directly involved in the performance of the day-to-day valuation tasks required to determine fair value,' but instead 'enlist the fund's investment adviser to perform certain of these functions.'"[2]

2. We agree with her stated views that:

   - "fund boards already have the experience and the wherewithal (as well as an existing legal obligation) to oversee, and ensure the adequacy, efficacy, and accuracy of, an adviser's valuation processes"
   - "[the Proposed Rule's] benefits may be diminished significantly by an overly prescriptive approach to ensuring adequate board administration of the fair valuation process" and
   - "[the Proposed Rule] should reflect th[e] reality [of current board oversight practices] rather than trying to overlay unnecessary duplicative requirements on top of it."[3]

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1 *Statement on Good Faith Determinations of Fair Value under the Investment Company Act of 1940 Proposal*, https://www.sec.gov/news/public-statement/statement-peirce-fair-value-2020-04-21 (Apr. 21, 2020).

2 *Id.*

3 *Id.*

We offer the following comments and suggestions regarding the Proposed Rule and related discussions in the Commission's release proposing Rule 2a-5[4] (the "**Proposing Release**") that we believe will further advance the Commission's goals stated in the Proposing Release that the new rule: (1) reflect the increased role that accounting and auditing developments play in setting fund fair value practices, (2) reflect the growing complexity of valuation and the interplay of Rule 38a-1[5] in facilitating board oversight of funds and (3) acknowledge the important role fund investment advisers currently play and the expertise they provide in the fair value determination process.[6]

SUMMARY OF COMMENTS

General Approach of the Proposed Rule. We believe that the Commission should adopt a more flexible and principles-based approach under which fund directors would be deemed to have fully performed their duties under Section 2(a)(41) of the 1940 Act in good faith when the board fulfills its oversight responsibilities in respect of fair valuation pursuant to Rule 38a-1 under the 1940 Act. The Proposed Rule is overly prescriptive in its minimum requirements for a board of directors to determine fair value in good faith as contemplated by Section 2(a)(41) of the 1940 Act. An alternative to both our recommended approach of crafting a flexible and principles-based rule and the more prescriptive rule proposed by the Commission would be for the Commission to issue formal Commission-level guidance addressing a board's responsibilities regarding valuation matters.

If the Commission determines instead to maintain the more prescriptive approach of the Proposed Rule in adopting a final rule, we strongly urge the Commission to structure the final rule to operate as a safe harbor. This approach would provide compliance certainty for fund boards to the extent they choose to rely on the rule, thereby reducing costs for funds and their investors, while allowing boards to use their experience to develop policies and procedures tailored to a fund's particular circumstances.

Performance of Fair Value Determinations. Proposed Rule 2a-5(b) would expressly permit a fund's board to "assign" the fair value determination for any or all fund investments to the fund's primary investment adviser, one or more sub-investment advisers, or any combination thereof,[7] subject to board oversight. We request that the Commission clarify (for example, in the release adopting a final rule) the differences, from the perspective of fund boards, among a board acting to "assign" a function and "delegate" a function or "designate" one or more responsible parties with respect to a function. At a minimum, the Commission should clarify that, once a board assigns fair value determinations to a fund's adviser:

- the board's role in fair value determinations will be limited to satisfaction of its oversight responsibilities; and
- the board will not be held responsible for any issues arising in connection with a fair value determined by an adviser as long as the board has fulfilled its oversight responsibilities.

The Committee seeks clarification of several matters relating to functions required by the Proposed Rule to effectively reach fair value determinations. In particular, we seek clarification on specific aspects of fair value functions, including the relative importance of valuation risks, an adviser's plans for managing the occurrence of significant events that could materially increase a fund's valuation risk, the level of focus on fair valuation determinations of individual holdings that are of a material size relative to a fund's portfolio as a whole, the frequency for re-assessing valuation risk, the development of valuation methodologies for new types of investments in which a fund merely "intends" to invest and the requirement to establish criteria to initiate price challenges. Finally, we recognize that accounting principles and related accounting rules may play an informative role in the valuation process but request clarification that such principles and guidance are not legal principles governing fair value determinations and acknowledgment that fair values arrived at in good faith that differ from what is subsequently viewed as appropriate from an accounting point of view do not result in fund director liabilities.

Board Oversight and Reporting. We believe that the Proposed Rule's prescriptive nature and departure from the current regulatory framework, together with some of the discussion in the Proposing Release, will impose unnecessary

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4 *Good Faith Determinations of Fair Value*, SEC Rel. No. IC-33845 (Apr. 21, 2020).

5 Rule 38a-1 under the 1940 Act (further discussed below) requires, among other things, a fund to adopt a compliance program and to designate a Chief Compliance Officer to be responsible for administering the fund's compliance program.

6 Proposing Release at 14.

7 Subsequent references in this letter to the activities of a fund's "adviser" encompass any board assignments of the fair valuation determination to the fund's primary adviser, one or more sub-investment advisers or a combination of the fund's primary adviser and one or more sub-investment advisers.

burdens and create confusion for boards by imposing inconsistent approaches to related topics. The expansive discussion in the Proposing Release of what constitutes board oversight seems overly prescriptive and ignores the well acknowledged principle that a board's oversight role is governed by fiduciary duties under state law. We also comment on the lack of clarity between the policies and procedures required by the Proposed Rule and by Rule 38a-1. In addition, we believe that the adviser's reporting to the board regarding fair valuation determinations, as required in the Proposed Rule and as discussed in the Proposing Release, is too specific and detailed. We recommend that boards be allowed, with limited exceptions, to determine the appropriate reporting that will assist them in carrying out their oversight responsibilities consistent with their fiduciary duties.

Rescission of Prior Commission Releases and Other Commission or Staff Guidance. We believe that the scope of Commission releases and staff letters and other guidance proposed to be withdrawn or rescinded is too limited. Accordingly, we urge that all previous Commission or staff guidance inconsistent with the Commission's final action should be expressly superseded.

The Commission Should Explicitly Permit Voluntary Early Compliance. We encourage the Commission to provide an option for funds to comply with the final rule prior to the compliance date, particularly if the new rule is structured as a safe harbor.

DISCUSSION

I. General Approach of the Proposed Rule

The Commission should adopt a more flexible and principles-based approach, consistent with that recommended in the Committee's July 2019 letter to the staff of the Division of Investment Management[8] (attached as Exhibit A, the "**Committee's 2019 Letter**"), under which fund directors would be deemed to have fully performed their duties under Section 2(a)(41) of the 1940 Act in good faith when the board fulfills its oversight responsibilities in respect of fair valuation pursuant to Rule 38a-1 under the 1940 Act.

As discussed in more detail below, we believe that the Proposed Rule is overly prescriptive in its minimum requirements for a board of directors to determine fair value in good faith as contemplated by Section 2(a)(41). We believe that, if the Proposed Rule is adopted as proposed, the rule would impose substantial additional compliance costs on funds (and their investors), which have not been fully accounted for in the Economic Analysis section of the Proposing Release (the "**Economic Analysis**") and would not provide fund boards with sufficient flexibility to determine how best to fulfill their obligations with respect to valuation matters based on a fund's particular circumstances. We believe that the approach recommended in the Committee's 2019 Letter would better take into account the wide variation in funds' operations, investment strategies and practices and would be significantly less burdensome for funds and their directors, particularly for smaller funds.

An alternative to both our recommended approach of crafting a flexible and principles-based rule and the more prescriptive rule proposed by the Commission would be for the Commission to issue formal Commission-level guidance addressing a board's responsibilities regarding valuation matters. However, if the Commission determines instead to maintain the more prescriptive approach of the Proposed Rule in adopting a final rule, we strongly urge the Commission to structure the final rule to operate as a safe harbor. This approach would provide compliance certainty for fund boards to the extent they choose to rely on the rule, thereby reducing costs for funds and their investors, while allowing boards to use their experience to develop policies and procedures tailored to a fund's particular circumstances.

A. The Commission Should Adopt the Approach Recommended in the Committee's 2019 Letter. We believe that, as recommended in the Committee's 2019 Letter, the best approach for the Commission to take with respect to a board's responsibilities regarding valuation matters would be for the Commission to adopt a rule clarifying that:

1. (a) fund directors' duties with respect to valuation matters are not subject to a different standard than other duties of directors under the 1940 Act, and (b) fund directors shall be deemed to have fully performed their duties under Section 2(a)(41) in good faith when the board fulfills its oversight

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[8] *Letter from the Federal Regulation of Securities Committee of the Business Law Section of the ABA to Dalia Blass and Paul G. Cellupica, Director and Deputy Director and Chief Counsel, respectively, of the SEC's Division of Investment Management* (July 22, 2019).

responsibilities pursuant to Rule 38a-1 under the 1940 Act, including by approving valuation policies and procedures that are reasonably designed to prevent violation of the 1940 Act;

2. subject always to the board's oversight responsibilities, (a) the board may reasonably rely on other parties, such as the fund's investment adviser, administrator or other appropriate parties, including the fund's independent registered public accounting firm, in fulfilling its statutory responsibilities, and (b) no additional specific actions by the board are necessary for the board to fulfill its obligation to "determine" fair value when the board does so rely;

3. when assessing directors' conduct in valuation matters, the Commission and its staff would recognize that (a) the board's role is one of oversight, and (b) it is expected that directors will exercise their reasonable business judgment in the performance of their oversight function; and

4. previous Commission or staff guidance inconsistent with 1. through 3. above, such as any guidance that may be interpreted to require that fund boards act in a management-like role rather than an oversight role in fulfilling their valuation responsibilities, is superseded.

When adopting Rule 38a-1 in 2003, the Commission's release[9] (the "**Compliance Programs Release**") specifically stated that a fund's compliance program should cover pricing portfolio securities and fund shares.[10] We discussed the requirements of Rule 38a-1 and its appropriateness for board fair value determinations in more detail in the Committee's 2019 Letter.

The principles-based approach of Rule 38a-1, requiring "reasonably designed" policies and procedures to address valuation and other compliance matters, has worked well for fund boards for many years, although we agree that boards would benefit from "additional clarity on how they can effectively fulfill their fair value determination obligations while seeking the assistance of others," including in particular the fund's investment adviser, especially "in light of the increased complexity of many fund portfolios and the in-depth expertise required to accurately fair value such complex investments."[11] Rule 38a-1's approach has allowed the Commission to bring enforcement proceedings to address violations of the federal securities laws regarding compliance matters. The Committee notes that the only violations identified by the Commission in a widely-publicized Commission enforcement action against fund directors of certain Morgan Keegan funds regarding the valuation of fund securities[12] (the "**Morgan Keegan Settlement Order**") were violations of Rule 38a-1.

The Economic Analysis states that the Commission considered, as an alternative to the Proposed Rule, "a more principles-based approach that would not specify the types of fair value functions that must be performed, but instead would only state that funds should have in place policies and procedures, reporting, and recordkeeping that would allow fair values to be determined in good faith by the board of directors or the investment adviser."[13] In discussing the reasons for not proposing a more principles-based approach, the Proposing Release states that, under such a principles-based approach:

- funds could be less certain of how to comply with the rule, potentially increasing compliance costs to the detriment of fund investors;
- the rule would not adequately ensure that the board provides sufficient oversight of the investment adviser's fair value determinations;
- the cost of board oversight could increase if funds within a fund complex with a shared board use the additional flexibility afforded by a more principles-based approach to set up policies and procedures, reporting and recordkeeping arrangements that are different from other funds within the fund complex; and

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9 *Compliance Programs of Investment Companies and Investment Advisers*, SEC Rel. No. IC-26299 (Dec. 17, 2003).

10 "[R]ule 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." *Id.* at II.A.2.c. (internal citations omitted) The Proposing Release states that, if adopted, Rule 2a-5's requirements would supersede this discussion in the Compliance Programs Release of the specific required policies and procedures regarding the pricing of portfolio securities and fund shares. Proposing Release at 28, n.69.

11 *See* Proposing Release at 14 (discussing feedback from boards in response to staff outreach).

12 *In the Matter of J. Kenneth Alderman et al.*, SEC Rel. No. IC-30557 (June 13, 2013) (settlement order).

13 Proposing Release at 104.

- there would not be a mandated minimum prescribed set of fair value policies and procedures, reporting and recordkeeping that would provide a consistent framework for funds to apply and, as a consequence, not all funds necessarily would put in place adequate policies and procedures, reporting, and recordkeeping to achieve accurate and unbiased fair value determinations.[14]

In addition, when requesting comment on whether a more principles-based approach relative to the Proposed Rule would be preferable, the Commission asked what safeguards would be necessary to ensure that fair value determinations are not influenced by conflicts of interest.[15]

The concerns articulated above by the Commission regarding a more principles-based approach appear not to be unique to valuation matters. It is not clear to us why these concerns necessitate a highly prescriptive rule in the context of the Proposed Rule but did not when the Commission adopted Rule 38a-1 or Rule 22e-4,[16] each of which, like the Proposed Rule, applies to important matters of day-to-day fund operations. Indeed, the board's role and responsibilities in valuation matters would seem to us to be substantially similar to its role and responsibilities in the similar contexts addressed by Rule 38a-1 and Rule 22e-4. When Rule 22e-4 was adopted, the Commission's release[17] (the "**Liquidity Management Programs Release**") stated that the board's oversight role in the context of fund portfolio liquidity is substantially similar to its role and responsibilities in other contexts under the 1940 Act and that providing a different standard of care for board action in that context would be inappropriate. One could theorize that the Commission attributes a special significance to board responsibilities in the area of valuation since the board's role is referenced in the 1940 Act itself rather than a rule thereunder. The Proposing Release, however, does not distinguish between board responsibilities identified in the 1940 Act and those in a rule under the 1940 Act, nor are we aware of any such distinction in publicly available guidance of the Commission or its staff.

The Committee's 2019 Letter noted that conflicts of interest between a fund and its adviser are inherent in the valuation process. Therefore, we would expect that valuation policies and procedures would seek to address and mitigate such conflicts, including conflicts identified in the Proposing Release such as those arising in the context of pricing challenges that could influence fair value determinations.[18] In other contexts, such as an investment adviser's fiduciary duty, the Commission has long viewed principles-based approaches as effective in safeguarding against conflicts of interest.[19]

B. <u>The Commission Should Consider Issuing Commission-Level Guidance in Lieu of Adopting a Final Rule</u>. As an alternative to both our recommended approach and the more prescriptive-based approach proposed by the Commission, we suggest that the Commission consider issuing Commission-level guidance addressing a board's responsibilities regarding valuation matters. This approach was recently adopted by the Commission in a similar context when it issued guidance relating to the proxy voting responsibilities of investment advisers ("**Proxy Voting Guidance**").[20] Commission-level guidance, like the Proxy Voting Guidance, could provide examples to help facilitate fund boards' compliance with their valuation responsibilities, but would not function as the only way by which a fund board could comply with the requirement to determine fair value in good faith as contemplated by Section 2(a)(41) of the 1940 Act.

This approach would have multiple benefits, including:

- allowing the Commission to leverage its experience in issuing the Proposed Rule and the feedback provided by commenters when developing the Commission-level guidance;
- enhancing compliance certainty for fund boards regarding their responsibilities with respect to fair value determinations and the assignment of fair value determinations to the fund's investment adviser;

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14 *Id.* at 104-5.

15 *Id.* at 111.

16 Rule 22e-4 under the 1940 Act (further discussed below) requires, among other things, funds to adopt a liquidity risk management program and that a person or persons be designated to administer the program.

17 *Investment Company Liquidity Risk Management Programs*, SEC Rel. No. IC-32315 (Oct. 13, 2016).

18 *See* the Committee's 2019 Letter under "3) The Board's Oversight Role and the Exercise of Reasonable Business Judgment—The board's oversight role—*Valuation procedures.*"

19 *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, SEC Rel. No. IA-5248 (June 5, 2019). *See also* Rule 38a-1 and Rule 22e-4.

20 *See Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers* (Aug. 21, 2019) (providing "examples to help facilitate investment advisers' compliance with their proxy voting responsibilities [which are] not the only way by which investment advisers could comply with their principles-based fiduciary duty imposed on them by the Advisers Act." *Id.* at 8.).

- providing examples of what the Commission views as sufficient board oversight of an investment adviser's fair value determinations;
- endorsing a consistent framework for developing valuation policies and procedures, reporting and recordkeeping (while not mandating that any specific approach be followed); and
- preserving flexibility for fund boards to determine how best to fulfill their obligations under the 1940 Act and state law with respect to valuation matters, taking into account a fund's particular circumstances.

If the Commission adopts this alternative approach, we recommend that the Commission take into account our comments set out in Sections II and III below in issuing such guidance.

C. A Highly Prescriptive Rule Should Operate as a Safe Harbor. If the Commission determines to maintain the more prescriptive approach of the Proposed Rule in adopting a final rule, we strongly urge the Commission to structure the final rule to operate as a safe harbor. The proposed text in paragraph (a) of the Proposed Rule—"determining fair value in good faith"—could be replaced with "a board of directors shall be deemed to have determined the fair value of a security or other assets in good faith if the following requirements are satisfied" and, consistent with other Commission rules that operate as safe harbors, the final rule text could be revised to state that the final rule is not intended to create any presumption that a board's fair value determination was not made in good faith as required by Section 2(a)(41) if a board elects not to conduct the fund's valuation process strictly in accordance with the requirements of the final rule. This approach would have similar benefits to issuing Commission-level guidance, as suggested above, by allowing the Commission to leverage insights gained in the notice-and-comment process to provide a framework that would enhance compliance certainty and preserve flexibility for funds and fund boards, while at the same time endorsing a consistent framework to address valuation matters. However, as with our recommended approach and Commission-level guidance alternatives, this approach would also recognize that a "one-size-fits-all" approach risks imposing unnecessary costs on some funds (and their investors), particularly smaller funds.

Structuring a Commission rule as a safe harbor is an approach the Commission has commonly taken[21] and would address in substantial part all of the concerns raised by the Commission in discussing its considerations of a more principles-based approach, as noted above. Importantly, this approach would provide certainty that board actions taken in "good faith" are not second-guessed with regard to fair value determinations when it complies with the specific conditions of the rule.

As with our alternative recommended approach for Commission-level guidance, if the Commission were to structure the final rule to operate as a safe harbor, we recommend that the Commission take into account our comments set out in Sections II and III below. We believe that these points will be particularly important in developing an effective safe harbor rule that is useful for fund boards that elect to follow the specific requirements of the rule, while not precluding other approaches a board may wish to take to fulfill its obligations to determine fair value in good faith.

II. Performance of Fair Value Determinations

A. The Board's Ability to "Assign" Fair Valuation Determinations to the Fund's Investment Adviser. Proposed Rule 2a-5(b) would expressly permit a fund's board to "assign" the fair value determination for any or all fund investments to the fund's primary investment adviser, one or more sub-investment advisers, or any combination thereof, subject to board oversight. Speaking in terms of the board's ability to "assign," rather than to "delegate" or "designate," fair valuations would be unique among the rules under the 1940 Act.[22] The words "assign," "delegate"

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21 The Commission has adopted several rules that operate as safe harbors, such as: Rules 3a-2, 3a-4 and 15a-2 under the 1940 Act; Rules 144A and 506(b) under the Securities Act of 1933, as amended; and Rule 10b-18 under the Securities Exchange Act of 1934, as amended.

22 For example, Rule 2a-7(j) permits the board of a money market fund to "delegate to the fund's investment adviser . . . the responsibility to make any determination required to be made by the board of directors" under the rule. (emphasis added) *See Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds)*, SEC Rel. No. IC-13380 (July 11, 1983) ("In meeting the rule's requirement that the fund invest only in those securities which the board determines to meet certain quality standards, the board may delegate to the investment adviser the responsibility for investigating and judging the creditworthiness of particular instruments." (emphasis added) *Id.* at *Quality of Portfolio Instruments.*). Similarly, Rule 17f-5(b) permits a fund's board to "delegate to the Fund's investment adviser . . . or to a U.S. Bank or to a Qualified Foreign Bank" certain responsibilities set out in the rule regarding the custody of a fund's foreign assets. (emphasis added). *See Custody of Investment Company Assets Outside the United States*, SEC Rel. No. IC-22358 (May 12, 1997) (Providing a fund's board with the ability to delegate its responsibilities under the rule "was intended to permit fund boards to play a more traditional oversight role in connection with a fund's foreign custody

and "designate" are not synonymous.[23]

Existing rules under which a board may delegate its responsibilities are predicated on ensuring that the board exercises adequate oversight of the adviser or other service provider. This generally requires, among other things, that the board adopt written policies and procedures and receive specific reporting to facilitate effective board oversight.[24] The Proposed Rule would similarly require, among other things, the adoption of written policies and procedures by the adviser (which, pursuant to Rule 38a-1, would be approved by the board) and board oversight of the adviser. It appears that the Commission is using the term "assign" as the functional equivalent of "delegate" as used elsewhere in the rules under the 1940 Act. Nonetheless, the Proposing Release maintains, consistent with prior Commission statements, such as those in the release issued in connection with adoption of amendments to Rule 2a-7 under the 1940 Act effecting "money market fund reform"[25] (the "**2014 Release**"), that the board may not "delegate" its responsibilities for determining fair value and may only "assign" determination of fair value to a fund's adviser.

The Committee requests that, when taking final action, the Commission clarify (for example, in the release adopting a final rule) the differences, from the perspective of fund boards, among a board acting to "assign" a function and "delegate" a function or "designate" one or more responsible parties with respect to a function. At a minimum, the Commission should clarify that, once a board assigns fair value determinations to a fund's adviser:

- the board's role in fair value determinations will be limited to satisfaction of its oversight responsibilities; and
- the board will not be held responsible for any issues arising in connection with a fair value determined by an adviser as long as the board has fulfilled its oversight responsibilities.

B. <u>Requirements for Fair Value Determinations</u>. Under the Proposed Rule, a fair valuation is to be determined by carrying out the functions specified in paragraph (a) of the Proposed Rule: (1) assessing and managing risks; (2) establishing and applying fair valuation methodologies; (3) testing fair valuation methodologies; (4) evaluating pricing services; (5) adopting and implementing fair value policies and procedures; and (6) recordkeeping. If the board assigns fair valuations to the fund's adviser, the adviser would carry out all of these functions, subject to the requirements of paragraph (b) of the Proposed Rule regarding board oversight and reporting.[26] We provide comments on three of these functions: assessing and managing risks; establishing and applying fair valuation methodologies; and evaluating pricing services.

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arrangements . . . [and] sought to recognize that in discharging their responsibilities under the rule, directors rely heavily on the analysis and recommendations of the fund's investment adviser, legal counsel and global custodian." (emphasis added) *Id.* at 14.)

On the other hand, Rule 38a-1 requires a fund's board to "[d]esignate one individual responsible for administering" the fund's compliance policies and procedures" (the CCO) (Rule 38a-1(a)(4)). Similarly, Rule 22e-4(d) requires a fund's board to approve the person(s) "designated to administer the program" (Rule 22e-4(b)(2)).

[23] According to Black's Law Dictionary (11th ed. 2019), to assign is "[t]o convey in full; to transfer (rights or property);" to delegate is "[t]o give part of one's power or work to someone in a lower position within one's organization;" and to designate is "[t]o choose (someone or something) for a particular job or purpose."

[24] For example, Rule 2a-7 requires that a board "establish and periodically review written guidelines . . . and procedures under which the delegate makes [its] determinations" and otherwise provide reasonable oversight of the investment adviser. Similarly, Rule 17f-5 requires a board to determine that it is reasonable to rely on the delegate, and the delegate must agree to exercise reasonable care, prudence and diligence in performing its duties, and to provide certain periodic written reports to the board. Rule 38a-1 and Rule 22e-4 also require board approval of policies and procedures, periodic reporting and designation of a party responsible for compliance and liquidity matters, respectively.

[25] *See* Proposing Release at 31-32, n.78 (citing *Money Market Fund Reform; Amendments to Form PF*, SEC Rel. No. IC-31166 (July 23, 2014) at n.890 and n.896) ("[i]t is incumbent upon the Board of Directors to satisfy themselves that all appropriate factors relevant to the fair value of securities for which market quotations are not readily available have been considered and to determine the method of arriving at the fair value of each such security." *Id.* at n.896.); and *In the Matter of Seaboard Associates, Inc. (Report of Investigation Pursuant to Section 21(a) of the Exchange Act)*, SEC Rel. No. IC-13890 (Apr. 16, 1984) ("The Commission wishes to emphasize that the directors of a registered investment company may not delegate to others the ultimate responsibility of determining the fair value of any asset not having a readily ascertainable market value . . . ." *Id.* at 430.).

[26] We have assumed in this letter that boards will choose to assign all of a fund's fair valuation determinations to the adviser, because we do not believe that a material number of boards will themselves choose to carry out the functions required to determine a fair valuation. As a result, while the Proposing Release refers to "boards or advisers" performing the functions covered in subsection (a) of the Proposed Rule, in this letter we assume that the adviser will perform these functions.

Valuation Risks. The first function specified in paragraph (a) of the Proposed Rule is "[p]eriodically assessing any material risks associated with the determination of the fair value of fund investments ("valuation risks"), including material conflicts of interest, and managing those identified valuation risks."[27] We agree with the Commission that assessing and managing identified valuation risks are important elements of determining fair value. However, we believe that the Commission should clarify that different valuation risks may be considered more or less important based on the nature of a fund's investments and/or the markets in which they trade, reliance on third-party service providers and other relevant circumstances. Alternatively, the Commission should provide guidance regarding the relative weights or priority that should be given to different types of valuation risks (particularly those listed in the Proposing Release (discussed immediately below)).

Specific Sources of Valuation Risk. The Proposing Release provides a non-exhaustive list of the types of sources of valuation risk[28] and requests comments on, among other matters, whether the Commission should further define what risks would need to be considered or provide guidance on the types of valuation risks that a fund may face. The following are comments and questions on certain types or sources of valuation risk included on the Commission's list.

- *Potential market or sector shocks or dislocations.*[29] The Proposing Release does not elaborate on this potential risk other than stating in a footnote that "[p]otential indicators of market or sector shocks or dislocations could include a significant change in short-term volatility or market liquidity, significant changes in trading volume, or a sudden increase in trading suspensions."[30] We do not believe that an adviser's assessment of valuation risks can realistically account for all potential future events that could change the valuation risk assessment, much less how a resulting increase in valuation risk would be managed.[31] We believe that, rather than suggesting consideration of potential future events as part of valuation risks, the Commission should clarify that the adviser's fair value policies and procedures, and/or other relevant adviser policies and procedures, should address the adviser's plans for managing the occurrence of significant events that could materially increase a fund's valuation risks.[32]
- *The proportion of the fund's investments that are fair valued as determined in good faith, and their contribution to the fund's returns.*[33] We request that the Commission clarify that the application of a risk-based approach to assessing and managing valuation risks would have a higher level of focus on fair valuation determinations of individual holdings that are of a material size relative to a fund's portfolio as a whole, since the valuation of such positions has a greater probability of affecting the fund's net asset value ("NAV").

Periodic Assessment of Valuation Risks. The Proposed Rule requires "periodically assessing" valuation risks.[34] The Proposing Release notes that the Proposed Rule:

> does not include a specific frequency for the required periodic re-assessment of a fund's valuation risks, as we believe that different frequencies may be appropriate for different funds or risks. We believe that the periodic re-assessment of valuation risk generally should take into account changes in fund investments, significant changes in a fund's investment strategy or policies, market events, and other relevant factors.[35]

The Proposing Release requests comment on whether a certain minimum frequency for re-assessing valuation risk should be required.[36] Consistent with other discussions in this letter regarding the relationship between the Proposed Rule and Rule 38a-1, we assume that the valuation procedures of the adviser that govern the adviser's fair valuation

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27 Proposed Rule 2a-5(a)(1).
28 Proposing Release at 17-18.
29 *Id.* at 17.
30 *Id.* at n.42.
31 As an example, we believe that few advisers, or any other businesses, had thoroughly planned and prepared for the sweeping impact of the COVID-19 pandemic, but it is generally believed that business continuity plans, while likely not specifically contemplating an event of the pandemic's type and magnitude, and other crisis management plans and procedures adequately served to minimize any impact of the pandemic on funds' operations, including fund valuation processes.
32 For example, in addition to business continuity planning, the operation of a fund's liquidity risk management program presumably will assist in identifying a pattern of decreasing market liquidity.
33 Proposing Release at 18.
34 Proposed Rule 2a-5(a)(1).
35 Proposing Release at 18.
36 *Id* at 19.

determinations for the fund[37] would be subject to annual review pursuant to Rule 38a-1 and believe that no separate minimum frequency for re-assessment of valuation risks is needed.

Fair Valuation Methodologies. The Proposed Rule would require selecting and applying in a consistent manner an appropriate methodology or methodologies for determining (including calculating) an investment's fair valuation, including (a) the key inputs and assumptions specific to each asset class or portfolio holding, and (b) the methodologies that will apply to new types of investments in which the fund intends to invest. The Proposing Release requests comment on whether the Proposing Release is clear in respect of "new investment types a fund may 'intend' to invest in."[38] We find this requirement particularly confusing. It is not clear at all what is meant by the phrase "intend to invest," as it could refer to anything from investments a fund is actively considering purchasing in the short term to investments that are merely described in a fund's offering documents that are permissible fund investments but in which the fund has not invested (and may never invest). As is the case with our comments above regarding "potential market or sector shocks or dislocations," we believe that an adviser's valuation policies and procedures cannot realistically account for potential future types of investments, much less how such investments would be valued.

The Committee notes that available information and services that can be used in fair valuation determinations evolve over time. For example, pricing services did not historically provide evaluated prices for certain derivative instruments, such as swap agreements, but they now provide evaluated prices for a variety of different types of swap agreements. In addition, the range and quality of services that a particular pricing service provides (including types of asset classes for which it will provide evaluated prices) change over time. Designating a specific pricing service in contemplation of a theoretically possible future investment seems unproductive and relying on the pricing service may be inappropriate if and when the particular investment is made.

While we do agree with the view that seems to be reflected in the Proposing Release that funds should and do generally establish how a new type of investment will be valued prior to purchasing the investment, we believe that valuation methodologies should not be required to apply to new types of investments in which a fund merely "intends" to invest. We recommend that this concept not be included when the Commission takes final action, or that the requirement be modified to cover "any new investment types in which a fund may invest in the future, prior to purchasing such investment." In addition, when taking final action the Commission should clarify that the adviser may revise its valuation procedures applicable to the funds, such as by adding or modifying valuation methodologies without prior board approval, to allow the final rule to operate to permit the addition or modification of methodologies by the adviser (subject to any requirements or limitations that may be imposed by the board), including for any new types of investments without unnecessary delay or burdens on either the adviser or the board overseeing the adviser's fair value determinations. This would seem to be consistent with the Commission's intended operation of advisers' valuation procedures, given that subsection (b) of the Proposed Rule requires quarterly board reporting of material changes to, or material deviations from, the established fair value methodologies.[39]

The Proposing Release requests comment as to whether it is feasible to establish a valuation methodology for all investments in advance and, if so, how the rule should address these situations.[40] In our experience, it is not possible to definitively establish a valuation methodology in advance for all investments. Situations where it is not possible to establish a valuation methodology in advance commonly arise in connection with circumstances not related to the nature of the investment itself but rather as a result of, for example, trading halts or market closures. For example, valuation procedures may provide that, in the event of the closure of trading markets in all or part of a country or geographic region, due to political unrest or a natural disaster, investments in companies within the affected country or region will be valued in accordance with movements in a corresponding American depositary receipt ("ADR") or, more broadly, movements in a large, well-established ETF focusing on investments in the affected country or region. When there is no such ADR or ETF to use as a valuation reference point, there likely is no alternative methodology

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37 Proposed Rule 2a-5(a)(5) requires that the adviser have in place valuation policies and procedures that are reasonably designed to achieve compliance with requirements of the fair value determination, including the requirement to periodically assess valuation risks.

38 Proposing Release at 23.

39 *See* the Compliance Programs Release at n.33: "Rule 38a-1 does not require fund boards to approve amendments to policies and procedures of the fund or its service providers. Such a requirement would, as commenters pointed out, inundate fund boards with review of minor changes and detract from their ability to address significant responsibilities committed to them by the Act and our rules. Moreover, such a requirement could delay funds and their service providers from making needed changes. Instead, the rule requires the fund's chief compliance officer to discuss material changes to the compliance policies and procedures in his or her annual report to the fund board."

40 Proposing Release at 23.

stated in the valuation procedures to guide valuation of these investments other than a facts-specific analysis of any information relevant to the investment and the markets in which it trades.[41] We believe that the Commission should acknowledge this possibility and state its expectations that, for fair valuation determinations for which a methodology cannot be determined in advance, a process be established for determining the appropriate fair valuation methodology.

C. Evaluating Pricing Services. The Proposed Rule would require, as part of fair valuation determinations by the adviser, overseeing pricing service providers,[42] if used, including establishing (1) the process for the approval, monitoring and evaluation of each pricing service provider and (2) criteria for initiating pricing challenges.[43] The Proposing Release provides as an example of such criteria the establishment of objective thresholds. We find it difficult to understand why requirement (2) is included in the Proposed Rule's requirements. In our collective experience, the vast majority of challenges do not result in the pricing service changing its evaluated price or the adviser using its own valuation to value a holding instead of the evaluated price provided by the pricing service (commonly known as an "override"). Since these challenges typically have no effect on fund valuations, the number and frequency of, and/or reasons for, a pricing service challenge in and of itself would not seem to be important, so it is unclear why criteria for the adviser to merely initiate a pricing service challenge are needed. If the Commission is concerned about an adviser's potential conflict of interest in challenging a pricing service's evaluated price (particularly in an effort by the adviser to raise the valuation), it would seem to be better addressed by focusing on circumstances of potential conflicts by, for example, requiring quarterly reporting of adviser overrides and the related circumstances to the board.

D. Role of Accounting and Auditing Developments in Fund Fair Valuations. The Commission drew significantly from the accounting profession for guidance in the development of the Proposed Rule. Throughout the Proposing Release are references to, and discussions of, U.S. generally accepted accounting principles ("**U.S. GAAP**"), Financial Accounting Standards Board ("**FASB**")[44] Accounting Standards Codification Topic 820, *Fair Value Measurement* ("**ASC Topic 820**") and accounting principles and related accounting rules promulgated by governing bodies of the accounting profession and focused on valuation for accounting purposes. We recognize that accounting principles and related accounting rules may play an informative role in the valuation process and that fund auditors may test some or all of a fund's fair valuations in connection with audit work. On the other hand, the legal standard applicable to fair valuations of securities in good faith pursuant to a fund board's obligation in Section 2(a)(41) of the 1940 Act may from time to time result in valuations that differ from those accountants or auditors might determine based on the applicable accounting principles, and we urge the Commission to clarify in connection with taking final action that there is no presumption that such differences are inconsistent with the fund board satisfying its legal obligations under Section 2(a)(41), and request clarification when the Commission takes final action that such principles and guidance are not legal principles governing fair value determinations and acknowledgment that fair values arrived at in good faith that differ from what is subsequently viewed as appropriate from an accounting point of view do not result in fund director liabilities.

The Committee notes that accounting rules are designed primarily to govern the preparation and review of periodic financial statements and are not meant to be part of a fund's daily valuation process. Accounting rules are relevant to fund valuations to the extent that they provide a process for comparing a limited set of asset positions at the end of a fiscal period, a process that takes a considerable amount of time to complete (for funds, up to 60 days after period end). Daily fund fair value determinations, on the other hand, must be made as part of the daily process to calculate the fund's NAV, generally within a short period of time after market close (usually 4:00 p.m., Eastern time). ASC Topic 820 was not created specifically as guidance for investment companies, but rather for operating companies that were adopting mark-to-market accounting. As with much accounting guidance, the effects on, and the concerns of, investment companies were not at the forefront in the formulation of the valuation-related standards of FASB.

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41 For example, in 2015, markets in Greece were closed and initially many funds valued their investment in Greek securities by reference to market movements in a U.S.-based ETF focused on investing in Greece. However, when the ETF stopped trading funds were left with no definitive valuation methodology to use in valuing their investments in Greece.

42 The Proposing Release clarifies that pricing services are third parties that regularly provide funds with information on evaluated prices, matrix prices, price opinions or similar pricing estimates or information to assist in determining the fair value of fund investments, citing to the 2014 Release.

43 Proposed Rule 2a-5(a)(4).

44 FASB is the independent, private-sector, not-for-profit organization that establishes financial accounting and reporting standards for public and private companies and not-for-profit organizations that follow U.S. GAAP. FASB is recognized by the Commission as the designated accounting standard setter for public companies.

III. Board Oversight and Reporting

The board oversight and reporting requirements in subsection (b) of the Proposed Rule (which must be complied with in order for the board to effectively assign fair valuation determinations to the fund's adviser), as augmented by the discussion in the Proposing Release, are both under- and over-inclusive. They also depart in significant ways from the approaches reflected in other rules under the 1940 Act relating to areas that boards oversee, specifically Rule 38a-1 and Rule 22e-4. The Proposing Release acknowledges this difference, stating that the Proposed Rule:

> [D]iffers from the current regulatory framework and funds' current practices in the following ways. First, under the current regulatory framework, funds have flexibility to determine their fair value policies and procedures, reporting, and recordkeeping requirements. The proposed rule would differ from the current regulatory framework because it would mandate more specific fair value practices, policies and procedures, reporting, and recordkeeping requirements and those requirements would be explicitly imposed on funds and performed by boards or advisers.[45]

The Proposed Rule's prescriptive nature and departure from the current regulatory framework will impose unnecessary burdens and create confusion for boards by imposing inconsistent approaches to related topics. Liquidity, in particular, is closely tied to valuation, and historically valuation risk becomes most acute during periods when liquidity is impaired. Board oversight requirements in respect of valuation should more neatly dovetail with the existing regulatory framework. We believe that the Proposed Rule's board oversight and reporting requirements should be modified as discussed below to better integrate board oversight responsibilities relating to valuation of a fund's portfolio.

A. Board Oversight Generally. As a general matter, we are concerned that the Proposing Release sets out a series of prescriptive instructions by which a board "should approach their oversight of fair value determinations assigned to an investment adviser of the fund."[46]

Directors carry out their oversight function subject to the duties imposed by state law,[47] whether developed by state statute, as in Maryland, or by common law as fiduciary duties, as in Delaware. The 1940 Act, the rules thereunder, Commission staff statements and case law augment these duties, but typically do so in the context of the oversight function and recognize that directors exercise their reasonable business judgment in fulfilling these duties.[48] The business judgment rule has been consistently recognized by the Commission.[49] Thus, the expansive discussion in the Proposing Release of what constitutes board oversight seems overly prescriptive and risks imposing management duties upon directors.

While there are no specific "oversight" requirements in the Proposed Rule other than receipt of reporting, the Proposing Release contains an expansive discussion of the Commission's expectations for board oversight of the adviser's fair valuation determination process. We believe that this discussion creates significant uncertainty and undermines long-settled standards with respect to applicability of the business judgment rule to a board's conduct of its oversight responsibilities. While mandating certain conduct and activities might be appropriate in the context of a safe harbor rule (if the Commission elects to take that approach), the Commission's release in connection with the

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45 Proposing Release at 89.

46 *Id.* at 35.

47 *Investment Company Governance*, SEC Rel. No. IC-26520 (July 27, 2004) at II.B.

48 While the business judgment rule is a state law concept (and so may vary state-to-state), Delaware corporate law is generally instructive. *See, e.g., Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (internal citations omitted):

> The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors. It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

In Maryland, the presumption in favor of directors' acts is stated in Section 2-405.1(g) of the Maryland General Corporation Law as follows: "An act of a director of a corporation is presumed to be in accordance with subsection (c) [setting forth the standard of conduct expected of a director] of this section." This presumption has been applied in, *e.g., Hartmann Commercial Props. REIT v. Hartman*, Civ. No. H-06-3897 (S.D. Tex. 2007); *Scalisi v. Grills*, 501 F.Supp.2d 356, 361 (S.D.N.Y. 2007).

49 *See, e.g.*, the Liquidity Risk Management Release, where the Commission stated that "the role of the board under [Rule 22e-4] is one of general oversight, and consistent with that obligation we expect that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors." (emphasis added) *Id.* at. 249. *See also Dist. Lodge 26, Int'l Ass'n of Machinists & Aerospace Workers, AFL-CIO v. United Techs. Corp.*, 610 F.3d 44, 52 (2d Cir. 2010).

adoption of a final rule that is not structured to operate as a safe harbor should include a discussion of the board's oversight process that is more in line with board oversight responsibilities in other contexts. We suggest that the specific suggestions in the Proposing Release as to how a board "might" exercise its oversight role and responsibilities be replaced and specifically superseded when the Commission takes final action with a clear discussion that the board's oversight role and responsibilities are substantially similar to its role and responsibilities in other contexts under the 1940 Act.

The following is a sampling of excerpts from the Proposing Release (emphases added) that we find particularly troubling. These statements could be read to suggest that the board is obligated to take specific actions and/or to review the entire valuation process at each quarterly meeting as opposed to approving valuation policies and procedures and overseeing their implementation, primarily through review of appropriate reporting. In brackets following each excerpt is commentary regarding our specific concern(s) about the excerpt. The Proposing Release states that boards "should":

- "approach their oversight of fair value determinations assigned to an investment adviser of the fund with a skeptical and objective view that takes account of the fund's particular valuation risks"[50] [This is problematic insofar as it differs from what is typically understood to be required under the business judgment rule.[51]]
- "view oversight as an iterative process and seek to identify potential issues and opportunities to improve the fund's fair value process"[52] [While ongoing oversight is appropriate, directors may lack the expertise to identify areas for improvement. Technical recommendations on improvements more typically come from the adviser. Boards should not be exposed to potential liability for failing to have identified issues that would have required a high degree of expertise to identify.]
- "seek to identify potential conflicts of interest, monitor such conflicts, and take reasonable steps to manage such conflicts"[53] [*See* discussion below on Risk Oversight.]
- "probe the appropriateness of the adviser's fair value process"[54] [It is unclear what "probe" means, but it seems to imply a more aggressive approach for the board's evaluation of information provided to it than is typically expected, and directors may lack the technical expertise to assess the appropriateness of the adviser's process; more typically, the adviser will report to the board as to the continued appropriateness of the fair value process and be available to respond to questions from the board.]

B. Intersection with Board Oversight for Other Rules.

Rule 38a-1. Rule 38a-1 requires funds to adopt fund compliance programs[55] and to designate one individual responsible for administering the compliance program, the fund's Chief Compliance Officer (the "**CCO**").[56] The compliance programs of the fund and its covered service providers,[57] as well as the designation and compensation of the CCO, must be approved by the board,[58] and the CCO has board reporting obligations.[59] The Commission's release in connection with the adoption of Rule 38a-1 noted that the board's role in compliance matters is one of oversight.[60] Rule 38a-1, when read together with the Commission's release,[61] makes clear the Commission's view that funds need to establish and maintain policies and procedures addressing fair valuation of portfolio securities.

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50 Proposing Release at 35.
51 *See supra* n.48.
52 Proposing Release at 35.
53 *Id.* at 36.
54 *Id.* at 37.
55 Rule 38a-1(a)(1).
56 Rule 38a-1(a)(4).
57 Rule 38a-1(a)(2).
58 Rule 38a-1(a)(4)(i).
59 Rule 38a-1(a)(4)(iii).
60 Compliance Programs Release at II.C.2.
61 "[R]ule 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. *Id.* at II.A.2.c. (internal citations omitted). It is interesting to note that the only violation cited in the Morgan Keegan Settlement Order was of Rule 38a-1: "It is a responsibility of a fund's board to ensure that the fund fulfills [its fair valuation] obligations, particularly with respect to policies and procedures concerning the determination of fair value." *Id.* at 9.

In our view, the Rule 38a-1 framework has worked successfully since its adoption and, for many boards, oversight of the valuation policies and procedures for a fund is largely conducted under the auspices of Rule 38a-1, although oversight of the valuation process is generally conducted separately. We believe that the Proposed Rule and the Proposing Release are not sufficiently clear on the interaction between Rule 38a-1 and the policies and procedures required by the Proposed Rule. This gap will create uncertainty and duplication if it is left unaddressed when the Commission takes final action.

One example of such a lack of clarity is the Proposing Release's suggestion that the adviser that has been assigned responsibility for fair value determinations would be required to adopt valuation policies and procedures that comply with the Proposed Rule, subject to board oversight under Rule 38a-1.[62] Discrepancies in the two rules exist, however, relating to how such board oversight would be conducted. Rule 38a-1 requires an annual review[63] of the adequacy of the policies and procedures of the fund and its covered service providers and the effectiveness of their implementation, but the annual review would not satisfy the more extensive reporting required in the Proposed Rule.

Rule 38a-1 also requires at least annual reporting of each "material compliance matter" as defined in Rule 38a-1.[64] The definition of material compliance matter is not aligned with the periodic or prompt reporting requirements and terminology of the Proposed Rule. "Material compliance matter" is defined to include "[a] weakness in the design or implementation of the policies and procedures of the fund" or its service providers.[65] Would "material deviations from [] the fair value methodologies," which the Proposed Rule would require be reported quarterly,[66] constitute a material compliance matter under Rule 38a-1? If such deviations were reported quarterly under the Proposed Rule, would that suffice for purposes of reporting under Rule 38a-1? For these purposes, is a "weakness" (from the definition of "material compliance matter" in Rule 38a-1) a "significant deficiency or material weakness" within the meaning of the Proposed Rule,[67] which would require "prompt" (within three business days) reporting to the board?[68]

Another example of a lack of clarity as to the interaction of the Proposed Rule and Rule 38a-1 is the suggestion in the Proposing Release that oversight of the valuation of sub-advisers could be performed under the auspices of Rule 38a-1.[69] However, Rule 38a-1 provides no guidance with respect to variances in valuation outcomes by different sub-advisers. It has been understood by the fund industry, based on prior Commission guidance, that different managers could arrive at different valuations, even within the same fund complex. In our view, this issue should be directly addressed by the Commission when it takes final action. The standard in Rule 38a-1 of "reasonably designed to prevent violation of the Federal Securities Laws" does not address the issue of different valuation results, which are by nature subjective. We suggest a structure similar to that found in Rule 22e-4 for different determinations as to liquidity,[70] especially since a liquidity determination may directly impact valuation.

Rule 22e-4. Rule 22e-4 requires boards of open-end funds (other than money market funds and certain exchange-traded funds) to adopt liquidity risk management programs and approve program administrators, but the Liquidity Management Programs Release specifically notes, among other things, that "boards are charged with oversight and not day-to-day management of funds' liquidity risk."[71] Unlike the Proposed Rule, the Liquidity Management Programs Release stated that the Commission believed "that the board oversight role here is substantially similar to its role and responsibilities in other contexts under the Investment Company Act and that providing a different standard of care for board action here would not be appropriate."[72] We believe a similar statement should be made by the Commission when taking final action. Liquidity is closely related to valuation, and the board oversight standard for these two functions should be equivalent.

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62 Proposing Release at 27.

63 Rule 38a-1(a)(3). The review is typically conducted by the CCO, and the review and its results and conclusions are typically reported to the board in the CCO's annual written report to the board that is required to address, among other things, the operation of the policies and procedures of the fund and each of its covered service providers. Rule 38a-1(a)(4)(iii)(A).

64 Rule 38a-1(a)(4)(iii)(B).

65 Rule 38a-1(e)(2).

66 Proposed Rule 2a-5(b)(1)(i)(B).

67 Proposed Rule 2a-5(b)(1)(ii).

68 *Id.*

69 Proposing Release at 34.

70 *Investment Company Liquidity Disclosure*, SEC Rel. No. IC-33142 (June 28, 2018) at 19-26.

71 Liquidity Management Programs Release at 221.

72 *Id.* at 251.

C. Risk Oversight. As a general matter, the board of a registered investment company plays a key role in the statutory framework for managing conflicts of interest.[73] The Proposed Rule recognizes this role and requires: (1) that determining fair value in good faith requires periodic assessment of material conflicts of interest; (2) that the board receive quarterly reporting on any material conflicts of interest of the investment adviser (and any other service provider); and (3) that the process of making fair value determinations be reasonably segregated from the portfolio management of the fund.

We agree with the observation in the Proposing Release that "[o]ne significant source of potential adviser conflicts of interest in the fair value determination process is the level and kinds of input that fund portfolio managers or persons in related functions have in the design or modification of fair value methodologies, or in the calculation of specific fair values."[74] We are concerned, however, that the phrase "reasonable segregation" is too subjective a standard to be embedded in the final rule. We believe that boards are well accustomed to addressing conflicts of interest between a fund and its investment adviser and that specific procedures and/or prohibitions in the fair valuation determination process should be left to the discretion of fund boards pursuant to the other provisions in the Proposed Rule.

D. Reporting. The adviser's reporting to the board regarding fair valuation determinations, as required in the Proposed Rule and as discussed in the Proposing Release, is too specific and detailed. We recommend that boards be allowed, with limited exceptions, to determine the appropriate reporting that will assist them in carrying out their oversight responsibilities consistent with their fiduciary duties. We note again the inconsistencies with certain of the reporting requirements under Rule 38a-1 and recommend that those be reconciled.[75]

Periodic Reporting. For most funds, valuation methodologies and procedures are fairly static, and we are concerned that quarterly reporting on issues that typically don't change from quarter-to-quarter would merely clutter the board materials and could result in boards paying less attention to more important matters in the valuation process. We recommend that quarterly reporting be limited to relevant material changes, which would eliminate, in the absence of any material changes, a perfunctory "summary" or "description"[76] of:

- the assessment and management of material valuation risks;[77] and
- the adequacy of resources allocated to the process for determining the fair value of assigned investments.[78]

In addition, given the control and expertise that the adviser has with respect to valuation, we believe that some form of certification from the adviser, similar to that provided under Rule 17j-1, stating that it has complied with the policies and procedures and that it has sufficient resources allocated to the process for determining the fair value of the assigned investments would be more meaningful than the proposed reporting on those matters.

In addition to the material required to be provided to a board under the Proposed Rule, the Proposing Release states that "it is incumbent on the board to request and review such information as may be necessary to be fully informed of the adviser's process for determining the fair value of fund investments." The Proposed Rule includes at the end of the list of required reporting items "[a]ny other materials requested by the board related to the adviser's process for determining the fair value of assigned investments."[79] We have the following concerns with this language.

- It places the primary burden on the board, even though the board may not be best positioned to identify what reporting would be most instructive. We suggest that, as in Section 15(c) of the 1940 Act, Rules 12b-1 and 18f-3 under the 1940 Act,[80] and in the staff's guidance on mutual fund distribution and sub-accounting fees,[81] a reciprocal obligation be imposed on the part of the adviser to furnish the board with such information as may reasonably be necessary for the board to evaluate the overall valuation process, including the adviser's process for determining the fair value of fund investments.

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73 *See, e.g., Investment Company Governance*, SEC Rel. No. IC-26520 (July 27, 2004) ("Fund independent directors play a central role in policing the conflicts of interest that advisers inevitably have with the funds they advise." *Id.* at II.A.)

74 Proposing Release at 54.

75 *See supra* "III.B. Intersection with Board Oversight for Other Rules."

76 Proposed Rule 2a-5(b)(1)(i)

77 Proposed Rule 2a-5(b)(1)(i)(A).

78 Proposed Rule 2a-5(b)(1)(i)(D).

79 Proposed Rule 2a-5(b)(1)(i)(F).

80 Rule 12b-1(d) and Rule 18f-3(d), respectively.

81 *Investment Management Guidance Update No. 2016-01*, Division of Investment Management, SEC (Jan. 2016).

- The language "any other materials" may be interpreted expansively by some boards and/or advisers as requiring the sort of "data dump" that the Commission does not seem to envision and that we view as unhelpful and inconsistent with the oversight role of a fund board.
- The language also could be interpreted as suggesting that the board would need a summary of each fair valuation determination and the methodology used, which seems to be at odds with the ability to assign fair valuation determinations to the adviser. We recommend that when the Commission takes final action it clarify that information should focus on trends and exceptions, rather than detailed reporting of resulting fair valuation calculations.

Reporting on Pricing Services. We have specific and significant concerns about board oversight of pricing services. The Proposed Rule requires a periodic report of any material changes to the adviser's process for selecting and overseeing pricing services, as well as any material events related to its oversight of such services, such as changes of service providers used or overrides.[82] The Proposing Release states that this information is designed to help the board oversee the adviser's use of pricing services, if applicable, and to help ensure that pricing information received from service providers serves as a reliable input for determining fair value in good faith.[83]

- *Board's Role Generally*. We believe that more clarity is needed regarding the board's role with respect to third-party pricing services used by a fund's adviser in making fair value determinations, particularly in light of statements in the 2014 Release that imply a higher level of board involvement than seems to be contemplated by the Proposed Rule or the discussion in the Proposing Release. Portions of the guidance in the 2014 Release (which is quoted from extensively in the Proposing Release) should be specifically withdrawn or clearly stated to be superseded when the Commission takes final action (further addressed below), including the following quoted excerpts from the 2014 Release:

> Before deciding to use evaluated prices from a pricing service to assist it in determining the fair values of a fund's portfolio securities, 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. In choosing a particular pricing service, a fund's board may want to assess, among other things, the quality of the evaluated prices provided by the service and the extent to which the service determines its evaluated prices as close as possible to the time as of which the fund calculates its net asset value. In addition, the fund's board should generally consider the appropriateness of using evaluated prices provided by pricing services as the fair values of the fund's portfolio securities where, for example, the fund's board of directors does not 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 in a current sale under current market conditions. (emphasis added)[84]
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> [...]
>
> We note that a fund's board of directors has a non-delegable responsibility to determine whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund's portfolio security. In addition, we have stated that "it is incumbent upon the [fund's] Board of Directors to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered." (emphasis added)[85]

- *Pricing Service Due Diligence Responsibilities*. We request specific clarification that the board may rely on the adviser's due diligence of pricing services when the board has assigned fair value determinations to the adviser. Directors typically do not have the expertise to evaluate the qualifications of a pricing service or the methodologies or inputs it uses. The Proposed Rule and discussion in the Proposing Release seems to support this position.

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82 Proposed Rule 2a-5(b)(1)(i)(E).
83 Proposing Release at 45.
84 2014 Release at 287-288 (internal citations omitted).
85 *Id.* at 286 (internal citations omitted).

- One of the specific requirements for fair value determinations is evaluating pricing services—overseeing pricing service providers, if used, including establishing (1) the process for the approval, monitoring and evaluation of each pricing service provider, and (2) criteria for initiating price challenges.[86]
- The Proposing Release states that the Proposed Rule would require that the adviser establish a process for the approval, monitoring and evaluation of each pricing service provider and lists certain factors the adviser "generally should take into consideration."[87]
- In discussing board reporting when the board has assigned fair valuation determinations to the adviser, the Proposing Release states that the adviser should disclose to the board certain matters regarding pricing services, such as when the adviser seeks to hire a new pricing service to cover a new asset type, and notes that, as part of the board's oversight and approval of the adviser's policies and procedures under Rule 38a-1, the board would generally be aware of an adviser initially appointing, and the establishment of the process for overseeing, a pricing service.[88]
- The Proposing Release includes among a list of types of reporting that a board may review and consider "[r]eports on the adviser's due diligence of pricing services used by the fund."[89]

However, the discussion of current practices in the Economic Analysis seems to contradict the discussion in the main part of the Proposing Release cited immediately above.

> Before engaging a pricing service, boards may review background information on the vendor, such as the vendor's operations and internal testing procedures, emergency business continuity plans, and methodologies and information used to form its recommended valuations. . . . Funds may establish procedures for ongoing monitoring of the pricing services—including pricing service's [sic] presentations to the board, investment adviser's due diligence, and on-site visits to the pricing service—to determine whether the pricing service continues to have competence in valuing particular securities and maintains an adequate control environment. Further, boards may seek to understand the circumstances under which the adviser may override the prices obtained by the pricing service provider. (emphasis added)[90]

- We suggest that the Commission, in articulating its view of the appropriate allocation of oversight of pricing services between the fund board and its adviser, consider the recent recommendations of the Technology and Electronic Trading Subcommittee of the Fixed Income Market Structure Advisory Committee regarding the use of independent pricing services for purposes of pricing transactions pursuant to Rule 17a-7 under the 1940 Act. According to the recommendations, fund advisers must be responsible for, and adopt policies and procedures covering, the selection and use of independent pricing sources, which require that:
  - pricing services meet objective independence standards that have been subject to due diligence and annual review and testing by the adviser;
  - the adviser utilizes other price confirmation inputs in order to confirm the reasonableness of the independent price ("independent price plus");
  - the adviser back-test and validate the independent pricing data; and
  - pricing sources are used in accordance with established policies designed to avoid cherry-picking prices.[91]

Potential Additional Types of Reporting. The Proposing Release contains, in addition to the reporting specified in the Proposed Rule, a separate list of potential types of reports "a board could review and consider, if relevant."[92] We believe that the inclusion of this list in the Proposing Release would be read by many boards, advisers and their respective counsel as in effect a requirement of the rule and that these items should, when the Commission takes final action, either be included as requirements or retracted in some fashion.

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86 Proposed Rule 2a-5(a)(3).
87 Proposing Release at 25.
88 *Id.* at 45, n.107, 108.
89 *Id.* at 47.
90 *Id.* at 78-79.
91 *Recommendation Regarding Modernizing Rule 17a-7 under the 1940 Act*, Technology and Electronic Trading Subcommittee of the Securities and Exchange Commission Fixed Income Market Structure Advisory Committee (June 1, 2020).
92 Proposing Release at 46-47.

"Prompt" reporting. The Proposed Rule's requirement for "promptly (but in no event later than three business days after the adviser becomes aware of the matter)" reporting to the board "on matters associated with the adviser's process that materially affect or could have materially affected the fair value of the assigned portfolio of investments, including 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"[93] does not reflect current common practices and is inconsistent with other types of reporting. Each of the listed matters is quite different in nature and requires a different reporting framework, which should be determined by a fund's board based on the relevant facts and circumstances.

- *Materially affect or could have materially affected the fair value of the assigned portfolio.* We suggest that materiality for reporting in this context be tied to existing practices relating to NAV errors. Under current fund industry practices, an NAV error is considered material if a pricing issue results in an NAV error exceeds $0.01 per share, with an error that exceeds 0.5% of the originally computed NAV requiring reprocessing of shareholder accounts. Given the literally thousands of NAV computations made daily, it is critical that there be a clear standard for materiality which would require board reporting. In this case, longstanding practice supports what should be deemed material, which we recommend be acknowledged by the Commission when taking final action.

- *Significant deficiency or material weakness in the design or implementation of the adviser's fair value determination process.* "Significant deficiency" and "material weakness" are accounting terms that are inapposite and may not cover all of the issues that may be experienced with respect to valuation. Moreover, use of the terms would seem to conflate accounting principles with a fund board's fair valuation responsibilities. A significant deficiency or material weakness generally applies to an internal control matter related to financial reporting and not to the quality of valuation methodologies. While we acknowledge the Commission's stated goal that the final rule reflect the increased role that accounting and auditing developments play in setting fund fair value practices, we believe that these particular concepts do not translate well into a standard for board reporting.[94]

- *Material changes in the fund's valuation risks.* In our collective experience, unexpected significant changes in the markets generally create a higher risk of material valuation issues and may call for heightened scrutiny by the board. We believe that material changes in a fund's current valuation risks should be promptly reported to the board. Recent history has shown that the market shocks created by, for example, the dot.com bubble, the 9/11 terrorist attacks, the financial crisis, and the current global pandemic may dramatically affect valuation risk for certain securities. Even relatively benign events such as the 2019 Japanese Golden Week may have an unexpected impact. We recommend that, to appropriately describe the types of material changes in valuation risks intended to be covered by the requirement, the adopting release reference as examples global political dislocations, natural disasters and pandemics as matters that may impact valuation risk.

- Finally, we submit that the three business day requirement is arbitrary. "Promptly" implies as soon as practicable under the relevant facts and circumstances. Since that timeframe will vary depending on the circumstances, we believe that the addition of the three-day reporting deadline serves no useful purpose in that it could be either too soon or too late.

E. Testing. In our experience, testing results generally provide the most useful information to boards regarding valuation results. We recommend that, in addition to reporting testing results to the board,[95] the adviser should be required to provide a narrative description of the results including any anomalies or exceptions noted.

IV. Rescission of Prior Commission Releases and Other Commission or Staff Guidance

A. Certain Commission Releases.

ASR 113 and ASR 118 Proposed to be Rescinded. We agree that SEC Accounting Series Release No. 113, *Statement Regarding Restricted Securities* (Oct. 21, 1969) ("**ASR 113**") and SEC Accounting Series Release No. 118, *Accounting for Investment Securities by Registered Investment Companies* (Dec. 30, 1970) ("**ASR 118**") should be rescinded. As stated in the Proposing Release, since that guidance was issued, developments in accounting standards of FASB have modernized the approach to accounting topics addressed in ASR 113 and ASR 118.

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93 Proposed Rule 2a-5(b)(1)(ii).
94 *See supra* "V.D. Role of Accounting and Auditing Developments in Fund Fair Valuations."
95 Proposed Rule 2a-5(b)(1)(i)(C).

2014 Release. As discussed above,[96] portions of the valuation guidance in the 2014 Release seem at odds with discussion in the Proposing Release, but this guidance is not proposed to be withdrawn or clearly stated to be superseded. On the other hand, helpful subsequent staff guidance on the evaluated price discussion in the 2014 Release is proposed to be rescinded. We believe that the portions of the 2014 Release discussing pricing services and evaluated pricing should be withdrawn or clearly stated to be superseded by the new rule. At a minimum, the staff guidance being withdrawn should be addressed in the adopting release as Commission guidance that supersedes the relevant evaluated price discussion in the 2014 Release.

Morgan Keegan Settlement Order. We believe that the Commission should specifically address the implication in the Morgan Keegan Settlement Order that the board may not place any reliance on the valuation work of a fund's independent registered public accounting firm performed in connection with the audit of the fund's annual financial statements.[97] While discussion in the Proposing Release contradicts this implication,[98] a more specific statement in the adopting release would provide needed assurance to boards and would be consistent with the Commission's stated goal that the final rule reflect the increased role that accounting and auditing developments play in setting fund fair value practices. We note in this regarding that the Proposing Release:

- lists "[t]he results of testing by the fund's independent auditor provided to the audit committee" as among the periodic reporting items that a board could review and consider as part of the board's oversight of the adviser's fair value determinations;[99]
- contemplates a shift away from Commission requirements and guidance on accounting- and audit-related matters in favor of deference to authoritative auditing standards and guidance;
- states that U.S. GAAP now provides authoritative standards applicable to the recognition, measurement and related disclosures for investment companies for financial reporting purposes; and
- states that neither the 1940 Act nor the rules thereunder currently define "readily available" (in the context of market quotations), but that the Commission understands that industry practice has developed to incorporate many of the concepts of ASC Topic 820 when evaluating whether market quotations are readily available.

B. Other Commission or Staff Guidance. While we do not object to the proposed withdrawal or rescission of the six staff letters and guidance identified in the Proposing Release (except the staff guidance relating to the 2014 Release, as discussed above), we believe that the scope of the Commission releases and staff letters and other guidance proposed to be withdrawn or rescinded is too limited. Although we recognize that the Proposing Release states that staff letters and guidance to be withdrawn or rescinded are not necessarily limited to the six identified staff letters and guidance, we believe that all previous Commission or staff guidance inconsistent with the final action taken by the Commission should be expressly superseded when the Commission takes such action.

As discussed in the Committee's 2019 Letter, the Division of Investment Management's valuation bibliography (the "**Valuation Bibliography**"), provided on the Commission's www.sec.gov website, contains a comprehensive list of valuation guidance, including select relevant provisions of the 1940 Act and related rules, Commission releases and enforcement actions and other Commission and staff guidance.[100] The Valuation Bibliography includes over 50 Commission releases in connection with enforcement proceedings dating as far back as 1943, a number of which are embedded with implicit Commission guidance regarding the actions (or inactions) of the charged parties. These releases are in addition to the dozens of other Commission releases (dating back as far as 1964) and other Commission and staff guidance listed in the Valuation Bibliography. Not all of the currently existing guidance can be harmonized to provide sufficient certainty to boards, and the existing lack of coherence could be further magnified when the Commission takes final action unless previous inconsistent guidance is addressed.

Many of the numerous source materials contained in the Valuation Bibliography explicitly or implicitly are not consistent, to varying degrees, with the Proposed Rule and the discussion in the Proposing Release and/or our comments and suggestions discussed herein.[101] We believe that, to effectively establish a consistent framework for

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96 *See supra* "III.D. Reporting—Periodic Reporting—Reporting on Pricing Services—Board's Role Generally."

97 Morgan Keegan Settlement Order at 9.

98 *See, e.g.*, Proposing Release at 45 (The board could review and consider "[t]he results of testing by the fund's independent auditor provided to the audit committee.").

99 Proposing Release at 46-47.

100 *See Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies – Select Bibliography of the Division of Investment Management*, https://www.sec.gov/divisions/investment/icvaluation.htm.

101 *See, e.g., supra* "III.D. Reporting—Periodic Reporting—Reporting on Pricing Services—Board's Role Generally."

fair valuations and a baseline standard of practices across funds, as the Proposing Release states the Commission is seeking to do with the Proposed Rule,[102] the Commission should explicitly state when it takes final action, that prior inconsistent Commission or staff guidance is withdrawn, rescinded or superseded, as appropriate.

V. The Commission Should Explicitly Permit Voluntary Early Compliance

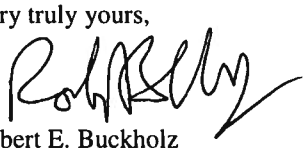
The Commission proposes an effective date of one year from the publication of any final rule in the Federal Register. The Commission also requests comments on other possible dates and transition arrangements, but does not appear to address, either positively or negatively, the possibility of voluntary early compliance. We encourage the Commission to provide an option for funds to comply with the final rule prior to the compliance date, particularly if the new rule is structured as a safe harbor. We believe at least some boards and advisers will be ready and able to meet the new requirements quickly and will desire to benefit sooner from the potential for increased compliance certainty. Given that the principal purpose of the one-year transition period is to allow industry participants time to adjust their practices to meet the new rule requirements, accommodating those who are ready to comply earlier would seem to be desirable. We also do not expect such a voluntary option to result in undue variation in practices greater than those that already exist or otherwise present complicated transition issues, whether for funds, advisers, boards, auditors, pricing services or Commission staff.

* * * * *

[102] Proposing Release at 14-15.

The Committee respectfully requests that the staff consider our comments and suggestions in connection with taking further action on the Proposing Release. Members of the Task Force are available to discuss these comments and suggestions should the staff desire to do so.

Very truly yours,



Robert E. Buckholz
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Exhibit A

July 22, 2019

Dalia Blass, Director
Paul G. Cellupica, Deputy Director and Chief Counsel
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Board Outreach Initiative—The Role of Fund Directors in Fair Valuation

Dear Ms. Blass and Mr. Cellupica:

This letter is submitted by the Federal Regulation of Securities Committee (the "Committee" or "we") of the Business Law Section of the American Bar Association ("ABA"). It was drafted by the Committee's Task Force on Fund Directors, which is comprised of members of the Investment Companies and Investment Advisers Subcommittee of the Committee in connection with Ms. Blass's public statements, as Director of the Division of Investment Management (the "**Division**") of the U.S. Securities and Exchange Commission (the "**Commission**" or "**SEC**"), regarding the Division's Board Outreach Initiative—specifically, the Division's interest in assisting boards of directors/trustees ("**boards**" or "**directors**") of investment companies ("**funds**") registered under the Investment Company Act of 1940, as amended (the "**1940 Act**"), in performing their valuation duties under the 1940 Act.[1] The mission of the Task Force is to promote the best interests of investors by sharing its members' collective knowledge and experience representing independent directors and communicate with the staff of the SEC about possible updates that might be made to the current regulation and guidance regarding the duties of fund directors.

The views expressed in this letter are those of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and should not be construed as representing the policy of the ABA. Further, this letter does not represent the official position of the ABA Business Law Section and does not necessarily reflect the views of all members of the Committee.

The stated goal of the Board Outreach Initiative is to review and reevaluate what fund boards are asked to do and to understand where board oversight is most valuable.[2] Ms. Blass has stated that, in staff meetings with directors conducted as part of the Board Outreach Initiative, directors almost uniformly stressed the importance of respecting the line between oversight and management, specifically in the areas of valuation and the review of affiliated transactions. She further explained that directors acknowledged that boards can play an important role in these areas because of the significant conflicts of interest that exist, but distinguished between "overseeing the work of experts and being asked to serve as experts."[3] Ms. Blass noted that,

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1 Dalia Blass, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, *Keynote Address, ICI 2018 Mutual Funds and Investment Management Conference* (Mar. 19, 2018) [hereinafter **March 2018 Speech**]. While discussion of the need for valuation guidance has been ongoing for some time, the Board Outreach Initiative seems to have focused both the staff and the industry on working toward solutions that address the relevant concerns.

2 Dalia Blass, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, *Keynote Address, ICI Securities Law Developments Conference* (Dec. 7, 2017) and March 2018 Speech.

3 March 2018 Speech.

accordingly, Commission staff had prioritized these areas for consideration[4] and, regarding valuation, been working on options for updating valuation guidance to reflect evolution in the markets and the standards for accounting, auditing and reporting to seek to develop recommendations to assist boards in performing their valuation duties under the 1940 Act in a way that recognizes this evolution and better serves investors.[5]

We share the staff's goal to assist boards in this manner and believe that boards need valuation guidance that reflects current markets and practices and the board's oversight role. Fund boards do not and cannot actually themselves value a fund's portfolio holdings on a daily basis, a reality that is not clearly and consistently reflected in Commission and staff guidance issued over time. In addition, valuation matters have become increasingly complicated, driven by the ongoing evolution of financial markets and the ever-increasing variation and complexity of available financial instruments and fund investment strategies and techniques.[6] Accordingly, we are submitting this request for guidance that reflects an extensive review of available Commission and staff guidance on valuation and board duties generally, our observations on current board valuation practices drawn from our considerable collective experience representing independent directors (as well as funds and their advisers), and our resulting recommendations for guidance that we believe can achieve our common goal.

SUMMARY OF REQUESTS AND RECOMMENDATIONS

We request that the staff propose that the Commission take action to clarify the following matters regarding fund board responsibilities under Section 2(a)(41) of the 1940 Act,[7] as further discussed below:

1. (a) fund directors' duties with respect to valuation matters are not subject to a different standard than other duties of directors under the 1940 Act, and (b) fund directors shall be deemed to have fully performed their duties under Section 2(a)(41) in good faith when the board fulfills its oversight responsibilities pursuant to Rule 38a-1 under the 1940 Act, including by approving valuation policies and procedures that are reasonably designed to prevent violation of the 1940 Act;
2. subject always to the board's oversight responsibilities, (a) the board may reasonably rely on other parties, such as the fund's investment adviser, administrator or other appropriate parties, including the fund's independent registered public accounting firm, in fulfilling its statutory responsibilities, and (b) no additional specific actions by the board are necessary for the board to fulfill its obligation to "determine" fair value when the board does so rely;
3. when assessing directors' conduct in valuation matters, the Commission and its staff would recognize that (a) the board's role is one of oversight, and (b) it is expected that directors will exercise their reasonable business judgment in the performance of their oversight function; and

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[4] We note that the staff has already taken action in the area of board review of affiliated transactions. Response of the Chief Counsel's Office, Division of Investment Management, to Amy B.R. Lancellotta, Managing Director of the Independent Directors Council [hereinafter **IDC**], dated October 12, 2018 [hereinafter **Exemptive Rule Guidance**].

[5] March 2018 Speech.

[6] Letter from Douglas Scheidt, Chief Counsel of the Division of Investment Management of the Commission, to Craig S. Tyle, General Counsel of the Investment Company Institute, dated December 8, 1999 [hereinafter **1999 Letter**] ("The development of world financial markets and the proliferation of new financial products have... complicated a board's responsibilities when fair value pricing portfolio securities...[T]hese new sources of information also have increased significantly the number of factors that a mutual fund board may need to evaluate when fair value pricing portfolio securities. This, in turn, provides additional challenges to fund directors, who may have to consider numerous alternatives when making complex decisions under tight time constraints."). Note that the 1999 Letter was issued 20 years ago, during which time there have certainly been even more changes in markets and financial products.

[7] Section 2(a)(41) provides, in relevant part (subsection (B)), for the "value" of a fund's assets to be determined: "(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 . . ." (emphasis added) While this letter addresses fund directors' duties in Section 2(a)(41) with respect to valuation generally, its focus is subsection 2(a)(41)(B)(ii) and the directors' obligation to determine in good faith the fair value of securities and other assets for which market quotations are not readily available. Substantially identical language is found in subsection 2(a)(41)(A)(ii) and in Rule 2a-4 under the 1940 Act (regarding determination of the net asset value of a redeemable security), which presents the same issues regarding fund director responsibilities as subsection 2(a)(41)(B)(ii). The discussion, requests and recommendations herein should be considered to apply equally to subsection 2(a)(41)(A)(ii) and Rule 2a-4.

4. previous Commission or staff guidance inconsistent with 1. through 3. above, such as any guidance that may be interpreted to require that fund boards act in a management-like role rather than an oversight role in fulfilling their valuation responsibilities, is superseded.

We believe that the requested Commission action should be the issuance of a proposal for public comment (the "**Commission Proposal**"), as either a proposed rule or a proposed interpretive release.

DISCUSSION

Below we discuss each of the four areas that we request be addressed in the Commission Proposal.

1) Standard for Fulfillment of Directors' Duties

We request that the Commission Proposal clarify that (a) fund directors' duties with respect to valuation matters are not subject to a different standard than other duties of directors under the 1940 Act, and (b) fund directors shall be deemed to have fully performed their duties under Section 2(a)(41) in good faith when the board fulfills its oversight responsibilities pursuant to Rule 38a-1 under the 1940 Act, including by approving valuation policies and procedures that are reasonably designed to prevent violation of the 1940 Act.[8] We request this clarification in the context of existing standards and precedents, as discussed below.

No different standard of care. We do not believe that directors should be held to a different standard with respect to their valuation responsibilities than they are with respect to their other obligations under the 1940 Act.[9] The fact that directors' valuation responsibilities are specifically included in the statute itself should not affect this conclusion. We are aware of no Commission or staff public statements or positions to the contrary, but we believe that Commission clarification of this point is needed in light of the current general lack of clarity around directors' responsibilities for valuation.

Application of Rule 38a-1. Rule 38a-1, among other things, requires funds to adopt compliance programs and assigns responsibility for administration of the compliance program to a fund's Chief Compliance Officer (the "**CCO**"). In its release adopting Rule 38a-1 the Commission expressed a view that the proper role of the board with respect to compliance matters is to oversee the fund's compliance program without becoming involved in the day-to-day program administration.[10] In adopting Rule 38a-1, the Commission identified pricing portfolio securities and fund shares as areas that a fund's compliance program should cover:

> [R]ule 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. (internal citations omitted)[11]

Specific fund board responsibilities in Rule 38a-1 are the following:

- approval (by the board, including a majority of directors who are not "interested persons" (as defined in the 1940 Act) of the fund ("**independent directors**")) of the fund's compliance policies and procedures and those of each investment adviser, principal underwriter, administrator and transfer agent of the fund (each, a "**Service Provider**"), which approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the "federal securities laws" (as defined in Rule 38a-1) by the fund and by each Service Provider;
- approval (by the board, including a majority of the independent directors) of the designation and compensation of the CCO;

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8 Since conflicts of interest between a fund and its adviser are inherent in the valuation process, we would expect that valuation policies and procedures would seek to address and mitigate such conflicts. *See infra* "3) The Board's Oversight Role and the Exercise of Reasonable Business Judgment—The board's oversight role—*Valuation procedures.*"

9 *See infra* "—Recently adopted Rule 22e-4 is instructive."

10 *Compliance Programs of Investment Companies and Investment Advisers*, Rel. No. IC-26299 (Dec. 17, 2003).

11 *Id.*

- approval (by the board, including a majority of the independent directors) of any removal of the CCO from his or her responsibilities;
- no less frequently than annually, receiving a written report from the CCO that, at a minimum, addresses:
  - (1) the operation of the policies and procedures of the fund and each Service Provider of the fund; (2) any material changes made to those policies and procedures since the date of the last report; and (3) any material changes to the policies and procedures recommended as a result of the annual review, required to be conducted no less frequently than annually, of the adequacy of the policies and procedures of the fund and of each Service Provider and the effectiveness of their implementation;[12] and
  - each "material compliance matter" (as defined in Rule 38a-1) that occurred since the date of the last report; and
- no less frequently than annually, the independent directors must meet separately with the CCO.

Violation of Rule 38a-1 was the sole violation identified by the Commission in the most recent Commission enforcement action involving fund boards' valuation responsibilities.[13] In the Morgan Keegan Settlement Order, the Commission, citing Rule 38a-1, stated that:

> Funds are required to adopt and implement policies and procedures reasonably designed to prevent violations of the securities laws, including policies and procedures concerning a fund's determination of the fair value of portfolio securities. It is a responsibility of a fund's board to ensure that the fund fulfills these obligations, particularly with respect to policies and procedures concerning the determination of fair value. (emphasis added)[14]

Recently adopted Rule 22e-4 is instructive. Rule 22e-4 under the 1940 Act, among other things, requires funds other than money market funds and certain exchange-traded funds[15] to adopt liquidity risk management programs. In adopting Rule 22e-4, the Commission stated its belief that the role of the board under Rule 22e-4 is one of general oversight, and Rule 22e-4 includes board oversight provisions related to a fund's liquidity risk management program.[16] The Liquidity Risk Management Release noted that the board, among other things, will approve, but not design, the fund's liquidity risk management program (similar to board responsibilities in Rule 38a-1 for approving compliance programs). As specific examples of the Commission's articulation of its board oversight approach in Rule 22e- 4, and analogies to other rules under the 1940 Act where the board's role is one of oversight, the Commission, in the Liquidity Risk Management Release:

- noted that it is not requiring, among other things, a fund's board to approve material changes to the fund's liquidity risk management program, referencing the requirements of Rule 38a-1, and stated that, instead, the board will be required to review, no less frequently than annually, a written report that describes, among other things, any material changes to the program (without any requirement to submit such changes for board approval);[17]
- stated that "fund boards are charged with oversight and not day-to-day management of funds' liquidity risk";
- responded to concerns of commenters on Rule 22e-4 in its initially proposed form regarding board responsibilities by, among other things, recognizing "that requiring mutual fund boards to make day-to-day determinations regarding the minimum amount of cash or illiquid assets the fund should hold may lead to a more detailed managerial role for the board"; and

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12 Rule 38a-1 states that the "fund" must conduct this annual review. Typically the CCO conducts the review.

13 *In the Matter of J. Kenneth Alderman et al.*, Rel. No. IC-30557 (June 13, 2013) (settlement order) [hereinafter **Morgan Keegan Settlement Order**].

14 We specifically request that the Commission Proposal clarify that use of the word "ensure" does not mean "guarantee" and was not intended to expand customary board duties as discussed herein. *See infra* "4) Inconsistent Commission or Staff Guidance is Superseded—Commission enforcement action."

15 Rule 22e-4 exempts from its requirements an "In-Kind Exchange Traded Fund" or "In-Kind ETF," defined in the rule as "an ETF that meets redemptions through in-kind transfers of securities, positions, and assets other than a *de minimis* amount of cash and that publishes its portfolio holdings daily."

16 *Investment Company Liquidity Risk Management Programs*, Rel. No. IC-32315 (Oct. 13, 2016) [hereinafter **Liquidity Risk Management Release**].

17 These requirements are similar to those in Rule 38a-1, which require that the CCO provide an annual written report to the board that addresses, among other things, any material changes to the policies and procedures recommended as a result of the annual review required by Rule 38a-1 (without any requirement to submit such changes for board approval).

- stated that "we believe that the board oversight role here is substantially similar to its role and responsibilities in other contexts under the Investment Company Act and that providing a different standard of care for board action here would not be appropriate."[18]

Notably, in the Liquidity Risk Management Release, the Commission withdrew its prior guidance regarding a board's responsibility for determining if securities eligible for transactions pursuant to Rule 144A under the Securities Act of 1933, as amended, are liquid or illiquid,[19] stating that:

> We recognize that the guidance in the Rule 144A Release anticipates that fund boards will determine whether certain securities are liquid or illiquid. While we have considered the specific guidance factors discussed in the Rule 144A Release in the context of the guidance we provide herein with respect to classifying the liquidity of portfolio investments, neither our guidance nor the final rule places the responsibility for determining whether a specific security is liquid or illiquid on the fund's board. The board would, however, be responsible for approving the fund's liquidity risk management program, which provides the framework for evaluating the liquidity of the funds' investments, and for reviewing (at least annually) a written report that describes a review of the program's adequacy and the effectiveness of its implementation. (emphasis added)

"Good faith" in Section 2(a)(41). No section of, or rule under, the 1940 Act sufficiently defines "good faith" for purposes of Section 2(a)(41), and there exists no legislative history or evidence of Congressional intent with respect to the definition of "good faith" or what it means for the board to "determine[] in good faith." The staff has stated that a board is not acting in good faith if it knows or has reason to believe that its fair value determination does not reflect the amount that might reasonably be expected to be received by the fund on a current sale, or if it acts with reckless disregard to whether its value determinations meet the board's statutory obligations.[20] However, neither the Commission nor the staff has provided guidance on what does constitute "good faith" in Section 2(a)(41) that we believe is sufficiently instructive to boards, and to those evaluating their conduct, given boards' significant responsibilities under Section 2(a)(41).[21] The absence of any clear standard by which to evaluate "good faith" in Section 2(a)(41), and the absence of any protection for determinations made in good faith pursuant to Section 2(a)(41), effectively reads "good faith" out of the board's valuation responsibilities in Section 2(a)(41).

2) **Reasonable Reliance**

We request that the Commission Proposal clarify that, subject always to the board's oversight responsibilities, (a) the board may reasonably rely on other parties, such as the fund's investment adviser, administrator or other appropriate parties, including the fund's independent registered public accounting firm, in fulfilling its statutory responsibilities, and (b) no additional specific actions by the board are necessary for the board to fulfill its obligation to "determine" fair value when the board does so rely.

Reasonable reliance on other parties—*Guidance on reliance in the valuation context.* Section 2(a)(41) places responsibility for fair valuations on directors, without any express provisions for delegation or reliance on other parties. It is commonly accepted that fund directors generally lack the technical experience and expertise to discharge effectively their statutory duty to make fair value determinations, and over time the Commission and the staff have

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18 Citing to the Commission's 2014 release adopting substantial changes to Rules 2a-7 and 17a-9 under the 1940 Act to effect "money market fund reform," *Money Market Fund Reform; Amendments to Form PF*, Rel. No. IC-31166 (July 23, 2014) [hereinafter **Money Market Reform Release**].

19 *Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145*, Rel. No. IC-17452 (Apr. 23, 1990) ("[D]etermination of the liquidity of Rule 144 securities in the portfolio of an investment company issuing redeemable securities is a question of fact for the board of directors to determine, based upon the trading markets for the specific security.")

20 Letter from Douglas Scheidt, Chief Counsel of the Division of Investment Management of the Commission, to Craig S. Tyle, General Counsel of the Investment Company Institute, dated April 30, 2001 (referencing ASR 118) [hereinafter **2001 Letter**].

21 In fact, other statements of the Commission and the staff have created uncertainty regarding how the "good faith" standard is satisfied, which we believe guidance in the Commission Proposal should clarify. *See, e.g.*, ASR 118 ("No single standard for determining 'fair value' . . . 'in good faith' can be laid down, since fair value depends upon the circumstances of each individual case.") and 1999 Letter (The staff stated that "good faith" is a "flexible concept" that can accommodate many different considerations and that the specific actions that a board must take in order to satisfy its good faith obligation under Section 2(a)(41) of the 1940 Act will vary, depending on the nature of the particular fund, the context in which the board must fair value price, and, importantly, the pricing procedures adopted by the board.")

acknowledged the permissibility of boards' reliance on, or delegation to, other, more appropriate parties for certain valuation-related responsibilities, subject to board oversight, including, without limitation, as discussed below.[22]

SEC Accounting Series Release No. 113, *Statement Regarding Restricted Securities* (Oct. 21, 1969),[23] which focused on funds' holdings of restricted securities, stated that boards may determine the method of valuing a restricted security while others may make the actual calculations:

> It is the responsibility of the board of directors to determine the fair value of each issue of restricted securities in good faith . . . While the board may, consistent with this responsibility, determine the method of valuing each issue of restricted security in the company's portfolio, it must continuously review the appropriateness of any method so determined. The actual calculations may be made by persons acting pursuant to the direction of the board. (emphasis added)

Subsequently, SEC Accounting Series Release No. 118, *Accounting for Investment Securities by Registered Investment Companies* (Dec. 30, 1970)[24] reiterated the statement in ASR 113 regarding calculations and then went further to recognize a board's ability to obtain "technical assistance": "To the extent considered necessary, the board may appoint persons to assist them [sic] in the determination of such value, and to make the actual calculations pursuant to the board's direction."

In the 1999 Letter, the staff discussed, among other things, the obligations of a fund's board for fair value pricing. The staff discussed how boards fulfill their obligations by reviewing and approving pricing methodologies (which are typically recommended, and applied, by fund management) and delegate certain responsibilities for fair value pricing to a valuation committee comprised of adviser personnel, including implementing the board-approved methodologies on a day-to-day-basis. In support of the oversight role of fund directors, the staff noted that, given that the board retains oversight responsibility for valuation of fund assets, "the board should receive periodic reports from fund management that discuss the functioning of the valuation process and that focus on issues and valuation problems that have arisen."

The Money Market Reform Release included guidance on valuation. The Commission included in the Money Market Reform Release valuation guidance for all funds—not just money market funds—on certain valuation matters. The Commission's statements on the use of pricing services generated significant discussion in the industry, particularly the statements regarding a fund board's consideration of the inputs, methods, models and assumptions used by a pricing service; board assessment of the quality of evaluated prices provided by a pricing service; and board consideration of the appropriateness of using a pricing service's evaluated prices when the board does not 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 receive upon sale.

Subsequent to the Money Market Reform Release, the staff issued responses to certain "frequently asked questions" related to the valuation guidance set forth in the Money Market Reform Release.[25] The Pricing Service FAQ stated that the valuation guidance was not intended to change the general nature of the board's responsibility to oversee the process of determining whether an evaluated price from a pricing service, or some other price, constitutes fair value, or to limit a board's ability to appropriately appoint others to assist in its duties. Notably, the staff stated that it believes that the board may delegate, subject to adequate oversight, specific responsibilities intended to assist the board in implementing the fund's valuation policies and procedures, including its due diligence of pricing services, but noted that it is still the board's obligation to satisfy itself that all appropriate factors relevant to fair value have been considered and to determine the method for determining the fair value of each security.

Reliance on valuation work of auditors. In the Morgan Keegan Settlement Order, despite the fact that the funds' auditors, during the relevant period, provided unqualified opinions on the funds' annual financial statements and advised the directors that the funds' valuation procedures were appropriate and reasonable, the Commission stated that the audits did not provide the directors with sufficient information about the valuation methodologies actually

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22 While portions of the sources quoted are cited for their support of a board's ability to rely on others in the valuation process as discussed herein, references to such sources are not meant to imply support for all views of the Commission or staff that may be expressed in such sources. As stated elsewhere herein, we believe that the Commission Proposal should confirm that previous Commission or staff guidance inconsistent with the Commission Proposal is superseded.

23 Hereinafter **ASR 113**.

24 Hereinafter **ASR 118**.

25 *See Valuation Guidance Frequently Asked Questions*, Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n (Feb. 11, 2016) available at: https://www.sec.gov/divisions/investment/guidance/valuation-guidance-frequently-asked-questions.shtml [hereinafter **Pricing Service FAQ**].

employed to satisfy the directors' obligations and noted that the auditors were not retained to opine on the funds' internal controls and, as a result, the Commission did not attribute any significance to the valuation work of the auditors or recognize any ability of the directors to rely on the auditor's valuation work. However, the activities at issue in the Morgan Keegan Settlement Order occurred over a decade ago, in 2007. Since that time, and even in the approximately six years since the issuance of the Morgan Keegan Settlement Order, there have been significant changes in the valuation work performed by auditors in the normal course of financial statement audits, including, among other things, an increased focus on the methodologies used by pricing services.[26]

As a matter of practice, directors do understandably take comfort in the reviews conducted by a fund's independent registered accounting firm in connection with the audit of the fund's annual financial statements, including such firm's reviews of pricing services' methodologies and reviews of securities' valuations as of the fiscal year-end, including those valuations for which a valuation methodology had not been pre-approved by the board by inclusion of the methodology in the board-approved valuation procedures (*i.e.*, Subjective Fair Valuations, as defined below), which valuations may be reviewed by the firm's valuation specialists.[27] The valuation work performed in connection with the audit, including any work of valuation specialists, is generally referenced by the independent registered public accounting firm in its presentations to the audit committee of a fund's board. It is therefore reasonable for the audit committee (which is frequently comprised of all or most of a board's independent directors) to attribute significance, at least as an input to valuation determination,[28] to the work of the firm and, as applicable, its valuation specialists.[29]

We believe that the Commission Proposal should repudiate the implication in the Morgan Keegan Settlement Order that a fund board cannot place any reliance on the valuation work of a fund's independent registered public accounting firm performed in connection with the audit of the fund's annual financial statements by specifically including within clarification of the board's ability to reasonably rely on appropriate parties reference to the fund's independent registered public accounting firm's valuation work performed in connection with its audit of the fund's annual financial statements. We believe that fund boards should be entitled to rely on input from any source that they reasonably believe to be appropriate and that a fund board may reasonably conclude that it is appropriate to consider the independent testing of valuations as of a fund's fiscal year end by experts in auditing and accounting and related statements by the fund's auditors, depending on the facts and circumstances including any qualifications provided by the auditors.

Guidance in other contexts. The Commission has in other contexts expressly permitted fund boards to rely on other parties with respect to, or to delegate, various board responsibilities where it is recognized that the directors generally do not possess the relevant knowledge or expertise, or where fund directors' responsibilities would exceed the traditional board role of oversight (*e.g.*, the board would play a more active role in day-to-day management than is

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[26] *See e.g., Public Company Accounting Oversight Board; Order Granting Approval of Auditing Standard 2501, Auditing Accounting Estimates, Including Fair Value Measurements*, Rel. No. 34-86269 (July 1, 2019) [hereinafter **Updated Auditing Standards Release**]. The Updated Auditing Standards Release adopted Auditing Standard 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* and related amendments to Public Company Accounting Oversight Board [hereinafter **PCAOB**] auditing standards [hereinafter **New Auditing Standards**] that, as stated in the Updated Auditing Standards Release, are intended to strengthen and enhance the requirements for auditing accounting estimates, including fair value measurements, by replacing the existing three standards with a single standard that sets forth a uniform, risk-based approach. Among the various changes to existing requirements effected by the New Auditing Standards are: (1) establishing requirements to determine whether pricing information obtained from third parties, such as pricing services and brokers or dealers, provides sufficient appropriate audit evidence and (2) requiring the auditor to understand, if applicable, how unobservable inputs were determined and evaluate the reasonableness of unobservable inputs.

[27] The larger independent public accounting firms that audit fund financial statements typically employ personnel, who they refer to as valuation specialists (or a similar designation), to review more complicated valuations. A fund may even be charged specifically for the work of valuation specialists.

[28] *See infra* note 45. *See also* ASR 118 (implication that auditors' reviews of securities carried at "fair value" are relevant, in discussion of materials that should be reviewed by the auditors to ascertain the procedures followed by the fund directors and whether in the circumstances the procedures appear to be reasonable and the underlying documentation appropriate).

[29] The Commission just recently approved amendments to certain PCAOB auditing standards for using the work of specialists. *Public Company Accounting Oversight Board; Order Granting Approval of Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*, Rel. No. 34-86270 (July 1, 2019) [hereinafter the **Valuation Specialists Release**]. The Valuation Specialists Release stated that the amendments were intended to strengthen the requirements that apply when auditors use the work of specialists in an audit including, among other things, a supervisory approach to both auditor-employed and auditor-engaged specialists and specific requirements such as factors for determining the necessary extent of supervision of the work of an auditor-employed specialist and factors for determining the necessary extent of review of the work of an auditor-engaged specialist.

typically thought of as appropriate for directors), including compliance programs,[30] liquidity risk management programs[31] and the operation of money market funds.[32] Regarding money market funds, the Commission has stated:

> In stating that certain functions are the responsibility of the board of directors, the rule does not require that the board personally become involved in the day-to-day operations of the fund . . . The board could delegate certain day-to-day functions to the investment adviser and still be in compliance with the rule. . . . [T]he Commission believes that, at a minimum, the board should have knowledge in advance of how the functions will be performed by the investment adviser; the board should assure itself that such methods are reasonable and provide any guidance necessary; and finally, the board should review periodically the investment adviser's performance.[33]

The Commission explained what reasonable reliance could entail in its release adopting significant changes to Rule 17f-5 governing foreign custody of fund assets:

> The Commission is adopting the proposed reasonable reliance standard. As stated in the Proposing Release, factors typically involved in making this determination include the expertise of the delegate and, if applicable, the delegate's intended use of third party experts in performing its responsibilities. Other relevant factors may include, for example, the board's ability to monitor the delegate's performance . . ."[34]

The staff recently issued a no-action letter[35] permitting board reliance on a written representation of a fund's CCO that transactions effected in reliance on Rule 10f-3, 17a-7 or 17e-1 under the 1940 Act (each, an "**Exemptive Rule**") complied with procedures adopted by the board pursuant to the relevant Exemptive Rule. The staff stated that this reliance would be "instead of the board itself determining compliance," notwithstanding that each Exemptive Rule requires, among other things, the board to determine that transactions pursuant to the Exemptive Rule were effected in compliance with the board-adopted procedures. The staff noted that the IDC's request letter stated that the purpose of its request was to better align board responsibilities under the Exemptive Rules with the oversight role that the Commission assigned to fund boards in Rule 38a-1 under the 1940 Act. The staff further noted that the IDC's request letter discussed that, in adopting Rule 38a-1, the Commission expressed a view that the proper role of the board with respect to compliance matters is to oversee the fund's compliance program without becoming involved in the day-to-day program administration.[36]

Given the number of securities and other investments held by most funds, as well as the complexity of the securities and other investments that may be held by such funds (and keeping in mind that many boards oversee a number of funds), we believe that boards' reasonable reliance on other appropriate parties in fulfilling their statutory responsibilities, subject always to the board's oversight responsibilities, is a practical necessity that should be explicitly recognized in the Commission Proposal.[37]

No additional specific board actions are necessary. In a 2012 webinar hosted by the Mutual Fund Directors Forum, Douglas Scheidt, the then-Chief Counsel of the Division, spoke at length on his views regarding board oversight of valuation,[38] including that the 1940 Act requires the board to "embrace"—by explicit approval, ratification or affirmation—a fair valuation determined by a delegate of the board outside the board pre-approved procedures:

> [W]hether you call it a ratification, or an affirmation, or call it something else, in my view, the board has to take that step to make the value a determination of its own. Because that, to me, is what the

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30 *See supra* "1) Standard for Fulfillment of Directors' Duties—Application of Rule 38a-1."

31 *See supra* "1) Standard for Fulfillment of Directors' Duties—Rule 22e-4 is instructive."

32 *See supra* "2) Reasonable Reliance—Reasonable reliance on other parties."

33 *Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds)*, Rel. No. IC-13380 (Jul. 11, 1983) (emphasis added) (release adopting Rule 2a-7 under the 1940 Act).

34 *Custody of Investment Company Assets Outside the United States*, Rel. No. IC-22658 (May 12, 1997) (emphasis added; internal citations omitted).

35 Exemptive Rule Guidance.

36 *See supra* "1) Standard for Fulfillment of Directors' Duties—Application of Rule 38a-1."

37 *See infra* "Requested Commission Proposal—Requests for the Commission Proposal—Goals of the Commission Proposal."

38 Douglas J. Scheidt, Assoc. Dir. & Chief Counsel, Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, *Remarks at Mutual Fund Directors Forum Webinar, Board Oversight of Valuation: The SEC's Perspective* (Sept. 20, 2012) (transcript not publicly available). At the beginning of the webinar, Mr. Scheidt stated the standard disclaimer of Commission staff members that his remarks are his own and do not necessarily reflect the views of anyone else at the Commission, the Commissioners or any other staff members.

> Act requires. And until that happens . . . there hasn't been a fair value determined in good faith by the board . . . I do not believe that the board could appoint a non-director to make [the valuation] determination that, in my mind, is the board's to make.

Mr. Scheidt also stated that the board must receive from the fund's adviser sufficient information to make fair value determinations:

> I have heard others question whether the board really needs to go through [the] process [of affirming or ratifying fair value]. . . . I think really the board, from a big picture perspective, has to have information that enables it to make a determination that the resulting valuations reflect fair value.[39]

Mr. Scheidt's comments during the webinar, which were stated to be a personal view and not necessarily the views of the Commission or the staff, nevertheless gave rise to some confusion in the industry regarding the need for a fund board to ratify or approve (i) fair valuations determined otherwise than by specific methodologies included in the fund valuation procedures (*i.e.*, valuations in circumstances for which a valuation methodology had not been pre-approved by the board by inclusion of the methodology in the valuation procedures and board approval of such procedures—typically relatively unique or fact-specific circumstances for which a methodology cannot be effectively established in advance ("**Subjective Fair Valuations**")), and/or (ii) the methodologies used to determine Subjective Fair Valuations. The Task Force members do not believe there is a universally accepted industry practice regarding this point. Accordingly, we believe that the Commission Proposal should specifically clarify that no additional, specific actions of the board, including board ratification or approval of Subjective Fair Valuations and/or the methodologies used to determine Subjective Fair Valuations,[40] are required for a board to fulfill its statutory responsibilities under Section 2(a)(41) other than as described herein.

If the Commission believes that additional review of Subjective Fair Valuations is needed, we suggest that it provide guidance to the effect that such additional review is appropriately conducted to the extent the fund's CCO provides to the board a written certification that all Subjective Fair Valuations during the relevant period were determined in compliance with the valuation procedures adopted by the board,[41] without necessitating board approval of Subjective Fair Valuations or their methodologies and the detailed board review that such approvals would necessarily entail, including review of information upon which to base a determination of each Subjective Fair Valuation. Reliance on the CCO's certification in this manner is consistent with the Exemptive Rule Guidance and the general board oversight frameworks of Rules 38a-1 and 22e-4, as discussed above. If the Commission believes that any further specific actions of the board are necessary for Subject Fair Valuations, such actions should be specified in the Commission Proposal and should be consistent with the board's accepted oversight function.

3) The Board's Oversight Role and the Exercise of Reasonable Business Judgment

We request that the Commission Proposal clarify that, when assessing directors' conduct in valuation matters, the Commission and its staff would recognize that (a) the board's role is one of oversight, and (b) it is expected that directors will exercise their reasonable business judgment in the performance of their oversight function.

The board's oversight role. The board's role is one of oversight.[42] Accordingly, fund directors typically are not involved in the day-to-day operations of the fund, and this includes valuation of fund assets. Fund directors regularly rely on other parties—most frequently fund management (fund officers employed by the fund's adviser or administrator and other adviser or administrator employees) and other service providers—for assistance in fulfilling their fiduciary duties, including those under the 1940 Act.

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[39] *Id.*

[40] We recognize that a particular board could choose to include in its valuation procedures adopted pursuant to Rule 38a-1 a policy to ratify or approve Subjective Fair Valuations and/or such methodologies, but we do not believe that these actions should be considered required in order for a board to fulfill its statutory responsibilities.

[41] *See infra* "3) The Board's Oversight Role and the Exercise of Reasonable Business Judgment—The board's oversight role—*Valuation procedures.*"

[42] *See* Paul F. Roye, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, *What Does It Take To Be an Effective Independent Director of a Mutual Fund?* (Apr. 14, 2000), *available at:* http://www.sec.gov/news/speech/spch364.htm ("You are not and should not try to be a full-time, day-to-day manager of the fund's operations. . . . You are responsible for oversight. You are there to act as a control and check on fund management. . . . You are not and cannot be the fund's auditor or the fund's lawyer. You are entitled to rely on reports and opinions by the fund's officers and the investment adviser . . . . You can also rely upon legal counsel, outside auditors and other experts . . . ." (emphasis added)).

The practical realities of the valuation process, and directors' role in the process, have long been recognized by the staff:

> Some commentators have suggested that, in light of the changes in securities and markets, mutual fund boards are ill-equipped to fair value price portfolio securities and that the obligations placed on boards by the 1940 Act are unworkable. Mutual fund boards . . . typically are only indirectly involved in the day-to-day pricing of a fund's portfolio securities. Most boards fulfill their obligations by reviewing and approving pricing methodologies, which may be formulated by the board, but more typically are recommended and applied by fund management. In reviewing and approving pricing procedures, boards should determine whether those methodologies and procedures are reasonably likely to result in the valuation of securities at prices which the funds could expect to receive upon their current sale. Mutual funds also may use a number of other techniques to minimize the burdens of fair value pricing on their directors. For example, a number of funds delegate certain responsibilities for fair value pricing decisions to a valuation committee. (emphasis added)[43]

Valuation procedures. In our collective experience, boards typically approve valuation procedures that govern a valuation process that is consistent with current Commission and staff guidance. These procedures:[44]

A. provide for the fund's investment adviser or administrator to perform the day-to-day valuation activities, such as calculation of fund asset values pursuant to methodologies in the procedures; these activities include valuation of:

   i. investments with a readily available market price from a pricing service that is essentially providing a data feed, not an evaluated price (*e.g.*, exchange-traded equity securities); or

   ii. investments without a readily available market price that can be valued:

   - at an evaluated price provided by a specified pricing service approved by the board, either implicitly by approval of the procedures naming the pricing services, and what types of asset(s) each service is used to value, or by specific approval of the pricing services (*e.g.*, most fixed income securities); or
   - by application of a prescribed methodology described in the procedures that is generally able to be implemented in a mechanical fashion with little or no subjectivity or judgment involved; a few examples include (i) a foreign stock that has halted trading in its local market, but for which an American depositary receipt ("**ADR**") is still trading, being valued by reference to the ADR's trading and (ii) valuing securities acquired in initial or secondary public offerings at cost for the period prior to the beginning of trading on an exchange;[45]

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[43] 1999 Letter. *See also Valuation and Liquidity Issues for Mutual Funds*, Investment Company Institute (Feb. 1997) ("Several factors make it especially impractical for fund boards, except in unusual circumstances, to have more than a limited involvement in the day-to-day pricing process. . . . Board members, particularly independent board members, cannot be expected to have the expertise required to evaluate the appropriateness of, much less to devise, specific pricing methodologies for particular securities. . . . [B]oard members cannot, as suggested by the ASRs, 'continuously review' the appropriateness of fund pricing methodologies. As a practical matter, therefore, boards generally delegate primary responsibility for both the development and the implementation of pricing procedures to those who have the substantive expertise, time and resources to discharge those functions effectively." (emphasis added))

[44] Investments in categories A.i., A.ii. and B. below generally correspond to Levels 1, 2 and 3, respectively, identified in Accounting Standards Codification 820, *Fair Value Measurement*. Similarly, investments in category A.i. generally correspond to Section 2(a)(41)(B)(i) of the 1940 Act, and categories A.ii. and B. are encompassed by Section 2(a)(41)(B)(ii) of the 1940 Act. While we describe in this section the types of provisions we typically see in fund valuation procedures, boards' approaches to exercising their valuation oversight role may vary depending on, among other things, the types of funds they oversee and the investment strategies and holdings of the funds.

[45] Quotations from broker-dealers also may be used in some instances, but regulatory and market changes over time have given rise to a significant decline in broker-dealers willing to make a market in securities by purchasing securities into their own inventory. As a result, broker-dealer quotations are more difficult to obtain and commonly are "indicative" only and do not represent a price that the quoting broker-dealer actually stands ready to pay for the security at issue. Consequently, funds tend to rely upon a broker-dealer quotation more frequently as an input into a fair value determination rather than as a "market quotation" at which to value a security pursuant to Section 2(a)(41)(B)(i). If a broker-dealer quotation is the primary basis for a fair valuation determination, there should be appropriate parameters set for the quotation, such as confidence in the ability of the broker-dealer to provide accurate quotations and an assessment that the quotation is an actionable, rather than merely an indicative, quotation.

B. address how subjective valuation determinations not covered by prescribed methodologies described in the procedures are to be determined; these valuations typically require the application of judgment to the specific circumstances and cannot be adequately addressed by a pre-approved methodology as described in 1.b. above), although the procedures should outline a process for determining valuation, including identifying what parties will be involved and those ultimately responsible for the final determination (frequently involving a committee comprised of appropriate adviser personnel), factors to be considered (as applicable) by the relevant parties and any involvement by the board or a board member or committee in the real time determination of the valuation (*i.e.*, if such parties will be involved in this stage of the process rather than only receiving subsequent notifications or reports); it is this category that has the least guidance, and the most uncertainty, for directors. A few examples include:

- privately-placed, restricted or other illiquid securities;
- certain over-the-counter derivatives;
- a security for which trading has been halted on the primary exchange following announcement of a significant development that is considered likely to affect the value of the security (such as accounting fraud or an acquisition);
- securities for which market quotations are believed to be unreliable;
- many business development company portfolio investments; and
- securities the value of which have been affected by the occurrence of a significant event, such as a catastrophic natural disaster, that has closed markets in the affected geographic area, causing securities for which such markets are primary markets to not trade, or when such an event occurs after the close of a foreign market but before the time as of which the fund calculates its net asset value, or other circumstances in which market closing prices (which would otherwise be considered a readily available market price and used for valuation pursuant to A.i. above are deemed to be unreliable;

C. provide for board oversight of the foregoing; oversight activities may include:

i. monitoring the implementation, operation and effectiveness of the valuation procedures and related processes, which may include, among other things, review of reports regarding:[46]

- all valuations pursuant to B. above, including the circumstances giving rise to the need for a fair valuation determination (*e.g.*, the reason for a trading halt instituted in the middle of a trading day), the process followed in determining the fair valuation, including factors considered, and other information reasonably necessary for the board to understand the determination and any other available relevant information, such as information regarding the fair value determined for other funds;
- results of back-testing, such as comparisons of (1) fair value prices (particularly valuations determined pursuant to B. above, but also including evaluated prices from pricing services) to sale prices and (2) comparisons of pricing service evaluated prices to prices from other pricing services;
- "challenges" to pricing service evaluated prices, whether the challenges are typically higher or lower that the challenged pricing service price, and the outcomes of the challenges (*i.e.*, whether or not the pricing service changed its price in response to a challenge);
- pricing service "overrides" (*i.e.*, rejection of a pricing service's price in favor of a different price when the pricing service price is determined not to reflect fair value), including the reason for the override, how the fair value actually used was determined and any data indicating the appropriateness of the override, such as the original (overridden) pricing service price being subsequently changed by the pricing service to a price closer to the fair value actually used;
- "stale" prices (securities for which the value, typically a pricing service evaluated price, has not changed for a specified number of days); and

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[46] Appropriate board reporting, and any other monitoring activities, will vary based on the relevant funds' strategies and investments, the party to which day-to-day implementation of valuation policies and procedures and related activities have been delegated, and the preferences and requests of the board and its counsel. The list that follows is intended only to provide representative examples of the types of reporting we see provided to boards.

- any use of broker quotes and, if appropriate, information substantiating the reliability of the quotes.[47]

Board reporting may be provided in a number of different formats, depending on the specific information being reported and what a particular board finds most useful. For example, reporting that generates voluminous data that may not be useful in its raw state (*i.e.*, a "data dump") typically is most useful to boards either presented as, or accompanied by, a summary of the information, such as the identification of outliers, significant changes from the prior quarter's report or other previous reporting over a period of time (to assist in identifying any trends), any other "red flags" that the data may indicate, and any potential conclusions that may be drawn from a detailed review of all the data.

ii. reviewing and approving changes to the valuation procedures, including changes in pricing services providing evaluated prices, and/or an annual review of valuation procedures regardless of whether changes are proposed; and

iii. reviewing management's due diligence of pricing services and their methodologies (including the inputs, methods, models and assumptions used by the pricing services and how they are affected, if at all, by market conditions) and management's recommendations regarding pricing services to be used in valuing fund securities or, alternatively (or additionally), the board may choose to receive presentations directly from key pricing services on a periodic basis or in connection with a determination to use a new pricing services;[48] and

D. seek to address and mitigate potential conflicts of interest between the fund and the adviser, such as the adviser's process in carrying out its responsibilities as specified in the valuation procedures, including the roles of adviser personnel involved in valuation (particularly, the composition of any adviser committee empowered to make certain valuation determinations and the role of portfolio managers, who generally should not have ultimate responsibility for valuation determinations but may be the most knowledgeable adviser employees about the issuer of securities being valued or trading in fixed income securities valued by pricing services).

The board's exercise of reasonable business judgment. State law generally assigns to fund directors the oversight of all fund operations, and the 1940 Act then assigns many specific responsibilities to fund boards.[49]

Fund directors are directors of corporations, or trustees of business or statutory trusts and serving a substantially similar role as directors of corporations (fund directors and trustees are referred to collectively herein as "directors") and subject to the laws of their funds' state of formation, which generally include the principles of the duties of care and loyalty, and directors' actions are typically evaluated in light of the exercise of their reasonable business judgment.

We believe that the 1940 Act and the duties and responsibilities it imposes on directors are an overlay to fund directors' basic state law responsibilities as corporate directors, with the 1940 Act imposing special duties on directors, but not raising or otherwise altering the state law standards by which directors' actions (or inactions) are evaluated. Most of these specific duties are focused on monitoring for and managing conflicts of interest between a fund and its adviser. As stated by the Commission:

> [T]he Act and our rules rely heavily on fund boards of directors to manage the conflicts of interest that advisers have with funds they manage. ... [A] fund adviser is frequently in a position to dominate the board because of the adviser's monopoly over information about the fund ... A fund board's primary responsibility is to protect the interest of the fund and its shareholders, which may be adversely affected by the substantial ongoing conflicts of interest of the fund management company.[50]

Noting that the 1940 Act requires that a majority of a fund's independent directors approve specific matters, the Commission has stated that "[i]ndependent directors play a critical role in policing the potential conflicts of interest between a fund and its investment adviser," additionally citing a number of matters required to be approved by fund boards, with the first matter cited being approval of the fund's valuation procedures.[51]

Conflicts of interest between a fund and its adviser are inherent in the valuation process, because fund advisers are incentivized for valuations of fund assets to be higher rather than lower since advisers are typically compensated based

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47 *See supra* note 45.

48 *See* the Pricing Service FAQ.

49 *Investment Company Governance*, SEC Rel. No. IC-26520 (July 27, 2004).

50 *Id.* (emphasis added)

51 *SEC Interpretation: Matters Concerning Independent Directors of Investment Companies*, SEC Rel. No. IC-24083 (Oct. 20, 1999).

on a percentage of fund assets and, in addition, a fund's favorable performance may attract additional assets into the fund, again raising the adviser's compensation. As a result, it is generally expected that valuation policies and procedures will seek to address and mitigate such conflicts, as discussed above.

We believe that the Commission Proposal should clarify that the Commission and its staff would recognize, when assessing directors' conduct in valuation matters, that it is expected that directors will exercise their reasonable business judgment in the performance of their oversight function,[52] including reliance on the advice of appropriate experts (*e.g.*, officers and employees of the fund's investment adviser and/or administrator, CCOs, fund counsel, independent legal counsel and independent registered public accounting firms). We are not asking the Commission to revisit its position, stated in the Money Market Reform Release, that it would not affirm that a board's deliberations would be entitled to the presumption of the business judgment rule, as we respect the Commission's position not to comment on matters of state law. However, we request that the Commission clarify that the Commission's position is not that state law standards do not apply.

4) **Inconsistent Commission or Staff Guidance is Superseded**

We request that the Commission Proposal state that previous Commission or staff guidance inconsistent with the principles addressed in the Commission Proposal, such as any guidance that may be interpreted to require that fund boards act in a management-like role rather than an oversight role in fulfilling their valuation responsibilities, is superseded. The Commission's valuation bibliography, provided on its www.sec.gov website, contains a comprehensive list of valuation guidance, including select relevant provisions of the 1940 Act and related rules, Commission releases and enforcement actions and other Commission and staff guidance.[53] The Valuation Bibliography includes over 50 Commission releases in connection with enforcement proceedings dating as far back as 1943, a number of which are embedded with implicit Commission guidance regarding the actions (or inactions) of the charged parties. These releases are in addition to the dozens of other Commission releases (dating back as far as 1964) and other Commission and staff guidance listed in the Valuation Bibliography. Not all of the existing guidance can be harmonized to provide sufficient certainty to boards and clear guidance for the Commission staff in evaluating director conduct in valuation matters, and there have been dramatic changes in the variety and complexity of fund investments since some of the earlier guidance was issued that calls for re-examination of the guidance in development of the Commission Proposal (*e.g.*, ASRs 113 and 118).[54]

Given the volume of source materials contained in the Valuation Bibliography, some of which explicitly or implicitly are not consistent, to varying degrees, with the principles we request be addressed in the Commission Proposal, we believe that, to effectively provide the guidance requested herein, the Commission Proposal should explicitly state that prior Commission or staff guidance inconsistent with such principles, such as any guidance that may be interpreted to require that funds boards should act in a management-like role rather than an oversight role in fulfilling their valuation responsibilities, is superseded. This includes, without limitation, statements that a board:[55]

- has a duty to "continuously review" valuation methodologies and/or the resulting valuations;[56]

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52 In the Liquidity Risk Management Release, the Commission stated that "the role of the board under [Rule 22e-4] is one of general oversight, and consistent with that obligation we expect that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors." (emphasis added) This request for the Commission Proposal closely tracks this Commission statement in the Liquidity Risk Management Release.

53 *See Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies – Select Bibliography of the Division of Investment Management, available at*: https://www.sec.gov/divisions/investment/icvaluation.htm [hereinafter **Valuation Bibliography**].

54 *See supra* note 5.

55 In addition, we specifically request that the Commission Proposal address a previous statement by a staff member regarding board ratification or approval of Subjective Fair Valuations and/or the methodologies used to determine Subjective Fair Valuations, *see supra* "Discussion—2) Reasonable Reliance—No additional specific board actions are necessary."

56 ASR 113. *See also, e.g.*, ASR 118, under the heading "Securities valued in good faith," which outlines a process that could be read to contemplate more director involvement than the oversight-based approach discussed herein (*e.g.*, "the findings of [persons appointed to assist the board in valuation] must be carefully reviewed by the directors in order to satisfy themselves that the resulting valuations are fair... [all] information [] considered [in determining fair value] together with, to the extent practicable, judgment factors considered by the board of directors in reaching its decisions should be documented in the minutes of the directors' meeting..." (emphasis added)).

- must be satisfied that each valuation is "based upon all of the appropriate factors that are available to the fund;"[57] and
- must "ensure" that a fund fulfills its obligations under Rule 38a-1, particularly with respect to policies and procedures concerning the determination of fair value.[58]

REQUESTED COMMISSION PROPOSAL

The requested Commission Proposal would assist fund boards in exercising their oversight responsibilities with respect to valuation by updating and clarifying the Commission's views in this area, including superseding prior inconsistent guidance. The Commission Proposal would also provide greater certainty to boards in their valuation oversight role and clearer guidance for the Commission and the staff in evaluating director conduct in valuation matters.

Requests for the Commission Proposal

Matters to be addressed in the Commission Proposal. We believe that the Commission Proposal should clarify the following matters regarding fund board responsibilities under Section 2(a)(41) of the 1940 Act:

1. (a) fund directors' duties with respect to valuation matters are not subject to a different standard than other duties of directors under the 1940 Act, and (b) fund directors shall be deemed to have fully performed their duties under Section 2(a)(41) in good faith when the board fulfills its oversight responsibilities pursuant to Rule 38a-1 under the 1940 Act, including by approving valuation policies and procedures that are reasonably designed to prevent violation of the 1940 Act;
2. subject always to the board's oversight responsibilities, (a) the board may reasonably rely on other parties, such as the fund's investment adviser, administrator or other appropriate parties, including the fund's independent registered public accounting firm, in fulfilling its statutory responsibilities, and (b) no additional specific actions by the board are necessary for the board to fulfill its obligation to "determine" fair value when the board does so rely;
3. when assessing directors' conduct in valuation matters, the Commission and its staff would recognize that (a) the board's role is one of oversight, and (b) it is expected that directors will exercise their reasonable business judgment in the performance of their oversight function; and
4. previous Commission or staff guidance inconsistent with 1. through 3. above, such as any guidance that may be interpreted to require that fund boards act in a management-like role rather than an oversight role in fulfilling their valuation responsibilities, is superseded.

We recognize that not all of 1. through 4. above may be readily addressed in the text of a rule, particularly 4. If the Commission proposes a rule and cannot readily address an item in the text of the rule, or if the Commission is otherwise not disposed to address one or more of these items within a proposed rule, we request that the Commission address the item(s) in the proposing and adopting releases for the new rule, as the Commission addressed the use of business judgment in the Liquidity Risk Management Release. However, we note that a Commission Proposal that does not address in some manner the "good faith" requirement in Section 2(a)(41) and recognize that it is expected that directors will exercise their reasonable business judgment in their oversight function would not address the present uncertainties, both in respect of standards for board conduct and for the Commission and the staff in evaluating director conduct in valuation matters.

The requested Commission Proposal would achieve the staff's goal. We believe that the requested Commission Proposal would achieve the staff's stated goal[59] of assisting boards in performing their valuation duties under the 1940 Act in a way that recognizes evolution in the markets and the standards for accounting, auditing and reporting and better serves investors.

The Commission Proposal would affirm that the board's role in the valuation process is in line with its accepted oversight role in similar contexts as discussed herein and would update, clarify and harmonize the application of decades of Commission and staff guidance scattered throughout the numerous sources cited in the Valuation

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57 2001 Letter.
58 Morgan Keegan Settlement Order.
59 *Supra*, p. 1.

Bibliography and explicitly supersede prior guidance that is inconsistent with the Commission Proposal. This uniformity would provide directors with needed assurances regarding the standards and expectations to which they are to be held in valuation matters and help ensure that all fund boards are exercising a similar and appropriate level of oversight rather than variations in practice due solely to a lack of clear guidance.

Form of the Commission Proposal

While the Commission Proposal could be issued in the form of a proposed interpretive release, we see no reason why the Commission should not propose and adopt a rule after notice and comment, given the significance of the matters that would be addressed. The issues we present would give the Commission the ability to take different approaches to a rule: proposing a definitional rule (clarifying the term "value" in Section 2(a)(41) (and the reference therein to "good faith")); an exemptive rule; or an interpretive rule. The Commission has broad authority to adopt a definitional rule under Section 38(a) of the 1940 Act, which provides it with "authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in this title, including rules and regulations defining accounting, technical, and trade terms used in this title." Further, under Section 6(c) of the 1940 Act, the Commission may exempt any transaction or class of transactions from any provisions of the 1940 Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the 1940 Act." An exemptive rule need not strictly "exempt" any persons or transactions from Section 2(a)(41), but rather could clarify how boards satisfy the requirements of Section 2(a)(41). Such an approach would seem to be "appropriate in the public interest and consistent with the protection of investors" as required by Section 6(c).

Rulemaking, rather than guidance issued in an interpretive release, is a more traditional way for the Commission to proceed, pursuant to the requirements of the rulemaking process, including those governing public notice and opportunity to comment. The Committee is of the view that the requested Commission guidance properly belongs within the rules promulgated under the 1940 Act, rather than in collateral guidance outside of the collection of rules under the 1940 Act. In any event, regardless of the form of the Commission Proposal, we strongly believe that it should be issued in proposed form with notice and an opportunity to comment. If the Commission issues guidance in the form of a proposed interpretive release, we ask that it eventually be adopted in some form or, if not, formally stated to be deemed withdrawn and that it is not intended to serve as guidance or represent the views of the Commission. If a proposed interpretive release is issued and not adopted, we believe that it has the potential to create even more uncertainty regarding boards' duties in respect of valuation (more so than a rule that is not adopted).[60]

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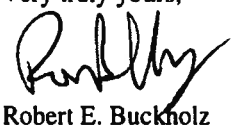
[60] *See, e.g., Commission Guidance Regarding Client Commission Practices Under 28(e) of the Securities Exchange Act of 1934*, Rel. No. 34-54165 (July 24, 2006).

The Committee respectfully requests that the staff consider our comments and recommendations for the Commission to issue the Commission Proposal as discussed herein. Members of the Task Force are available to discuss this request should the staff desire to do so.

Very truly yours,



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