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Via e-mail: rule-comment@sec.gov
Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street Northeast
Washington, DC 20549-0609

RE: Comment on Proposed Rule 2a-5 (Good Faith Determination of Fair Value) Release No. IC–33845; File No. S7-07-20; RIN 3235-AM71

Dear Secretary Countryman:

The University of Miami School of Law Investor Rights Clinic ("the IRC")[1] appreciates the opportunity to comment on Proposed Rule 2a-5 (Good Faith Determination of Fair Value) under the Investment Company Act of 1940 (the "Investment Company Act" or the "Act")—which is intended to address valuation practices and the role of the board of directors with respect to the fair value of the investments of an investment company or business development company (a "fund") under Section 2(a)(41).[2] The IRC supports the SEC's efforts to update its regulatory framework for making good faith fair value determinations when market quotations are not readily available—especially, for unlisted, non-traded securities. We write on behalf of our clients–unsophisticated, and often senior, investors who are adversely impacted by unavailable, erroneous, or misleading valuations. Thus, the IRC advocates for strengthening the regulatory framework by (i) providing sufficient pricing transparency to protect unsophisticated investors from opaque valuations and through (ii) erecting an ethical screen between the fund and its investment advisers to foster investor confidence in fair valuations and safeguard the objectivity and independence of those determining fair values.

The IRC supports the reasonable alternative the SEC considered in the Proposal of "not permitting fund boards to assign the fair value determinations to an investment adviser to the fund but instead only requiring funds to adopt the policies and procedures, reporting, and recordkeeping

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[1] Launched in 2012, the IRC provides *pro bono* representation to investors of modest means who have suffered investment losses as a result of broker misconduct but, due to the size of their claims, cannot find legal representation. The IRC is the only *pro bono* organization in Florida available to investors asserting claims in FINRA arbitration. To date, the IRC has recovered more than $1,100,000 on behalf of investors.

[2] Good Faith Determinations of Fair Value, SEC Release No. IC-33845 (Apr. 21, 2020) at 1, available at https://www.sec.gov/rules/proposed/2020/ic-33845.pdf ("Proposal ").

as described in the proposed rule."[3] The IRC largely agrees with the first part of Proposed Rule 2a-5 that establishes six requirements for determining fair value in good faith: (i) valuation risk assessment; (ii) fair value methodology selection and application; (iii) methodology testing; (iv) pricing services oversight and evaluation; (v) policies and procedures adoption and implementation; and (vi) recordkeeping. However, we recommend a more prescriptive approach to valuation risk assessment, with bright-line rules where feasible to ensure that all investors have ample information to make informed financial decisions. The IRC opposes the second part of Proposed Rule 2a-5 that permits fund boards to assign this determination to its investment advisers or sub-advisers because the ensuing conflicts of interest will inevitably compromise the integrity of the fair values.

The IRC advocates for a mandated assessment frequency and minimum set of risk factors for the proposed rule requirement that boards assess and manage material valuation risks. The Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act")[4] can provide the SEC with guideposts for developing the technical aspects—specifically assessment standard and reporting timelines—of the finalized rule. The mandated minimum set of risk factors can be the same as the non-exhaustive list of potential sources of valuation risk identified in the Proposal: (i) material conflicts of interest identification and management; (ii) potential market or sector shocks; (iii) unobservable inputs use; (iv) proportion of fairly valued investments in the fund; (v) overreliance on service providers with more limited expertise in relevant asset classes, for inputs into fair value methodologies, or that rely on their own service providers ("fourth party" risks); and (vi) inappropriate or incorrectly or inconsistently applied methodologies.[5] Funds can still tailor additional risk factors to their unique characteristics, and the IRC believes that the SEC could facilitate this adoption by helping to identify best practices among funds sharing commonalities in overall size, asset class focus, and available resources.

The IRC opposes permitting boards to assign responsibility for fair value determinations to investment advisers. We disagree with the SEC's position that dismantling the ethical screen between the fund and its investment advisers will not adversely impact fund governance.[6] Rather, the IRC believes conflicts of interest by investment advisers will unavoidably bias the fair value process that the Proposal only warns of as a possibility:

> [F]und investment advisers have conflicts of interest, which could bias the fair value process. In particular, investment advisers have incentives to inflate fund asset values (or deflate fund liability values) because they typically receive a management fee that is calculated as a percentage of the value of assets under management. Relatedly, investment advisers have incentives to inflate fund asset values because investors tend to invest more in funds that performed well in recent periods, which would increase assets under management and ultimately increase investment advisers' compensation. Investment advisers also have incentives to

[3] *Id* at 107.

[4] Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745.

[5] Release, *supra* note 2, at 17-18.

[6] *Id* at 107.

mismeasure fund investments in a way that would result in smooth reported fund performance over time to lower the funds' perceived risk.[7]

The IRC supports an ethical screen at investment adviser or portfolio manager levels to prevent conflicts of interest, or if not adopted, a more prescriptive approach for proper Specification of Duties. The IRC supports an ethical screen between the fund and its investment advisers because even non-portfolio managers in an investment adviser performing fair valuations have conflicts of interest (e.g. owning company stock, career advancement, etc.). But if the SEC permits fund boards to assign fair value determination to its investment advisers or sub-advisers, the IRC then advocates for an ethical screen prohibiting portfolio managers from having any involvement in the fair value process based on the same conflicts of interest mentioned above. If the SEC opposes erecting an ethical screen at the investment adviser or portfolio manager levels, then the SEC should adopt a more prescriptive approach for proper Specification of Duties as the Sarbanes-Oxley Act does in satisfying Section 404 requirements or as the Committee of Sponsoring Organizations of the Treadway Commission (COSO) does in its Internal Controls – Integrated Framework.[8] The principles-based approach of the Proposal emphasizing self-regulation that merely requires the board to take "reasonable steps" in overseeing the adviser and the adviser to "reasonably segregate" the fair value determination process does little to protect investors and instill confidence in the trustworthiness of these fair value determinations.

Finally, if the SEC permits fund boards to assign fair value determinations to its investment advisers or sub-advisers, the IRC would support the SEC's proposed three-day time period conditional on inclusion of a more prescriptive approach for assessing and managing material valuation risks as discussed above. A mandated assessment frequency and minimum set of risk factors will ensure that the SEC's proposed three-day time period for prompt reporting of matters that materially or could have materially affected a fund's fair value is sufficient. Increased monitoring will reduce the gap between the occurrence and awareness of events. A stronger grasp of the matters that materially or could have materially affected the fair value of the fund's investments will enhance response readiness for advisers to produce these reports to boards. The concern with using a principles-based approach for both valuation risk assessment and prompt reporting is the corresponding increased probability that material risks are underreported whether due to willful unawareness of events, insufficient knowledge, or disagreements about "materiality." These risk factors could also be mitigated by inclusion of language that the prompt reporting period is the earlier of (1) a certain number of business days after the event occurs,[9] and (2) the third day on which the investment adviser becomes aware of the event. The SEC has used

[7] *Id* at 87-88.

[8] COSO is a private-sector organization that provides frameworks and guidance on organizational governance, business ethics, internal control, enterprise risk management, fraud, and financial reporting. It was formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private-sector initiative which studied the causal factors that can lead to fraudulent financial reporting. In the adopting release for the initial rules implementing Section 404, the Commission noted that the rules require management to base its evaluation of the effectiveness of the company's internal controls on a suitable framework and, while the rules do not mandate use of a particular framework, the COSO framework satisfies the Commission's criteria and may be used for management's evaluation and disclosure requirements. See Release No. 33-8238 (Jun. 5, 2003).

[9] A certain number of business days is the amount of time the SEC thinks an investment adviser reasonably monitoring the account should become aware of a material risk.

similar language elsewhere (e.g. Exchange Act Form 8-K[10]) to balance the need for action from when an event occurs with acknowledgement that prompt reporting can only occur once an investment adviser becomes aware of the event.

The IRC appreciates this opportunity to comment on Proposed Rule 2a-5. The IRC is committed to protecting investors of modest means who have fallen victim to investment schemes that are not reflective of the SEC's commitment, nor the majority of the financial industry's commitment, to fair and honest dealings. Our advocacy for Proposed Rule 2a-5 to strengthen the regulatory framework governing good faith fair value determinations without compromising the current statutory duties of fund boards should ensure that these and other investors have sufficient, timely, and reasonably accurate information to make sound financial decisions.

Respectfully submitted,

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[10] See Exchange Act Form 8-K Question 107.01 regarding Creation of a Direct Financial Obligation under an Off-Balance Sheet Arrangement of a Registrant (December 22, 2017), available at https://www.sec.gov/divisions/corpfin/guidance/8-kinterp.htm.