

July 23, 2020

Office of the Secretary Vanessa Countryman
Securities and Exchange Commission
100 F Street, NE,
Washington, DC 20549-1090
Email: rule-comments@sec.gov

File Number S7-07-20

Dear Secretary Countryman and Members of the SEC,

As a securities valuation firm with more than 25 years of experience in financial reporting, Harvest Investments, Ltd. greatly appreciates the opportunity to comment on the SEC’s proposed valuation framework update, “Good Faith Determinations of Fair Value.” We are very encouraged that the Commission is addressing this important issue, and we think this issuance represents a welcome and significant step forward. Fund assets have continued to grow, having increased fourfold since 1998¹, and Main Street is heavily invested in mutual funds. At the same time, markets and financial instruments have both become increasingly complex. This combination of factors makes the Commission’s present work both timely and necessary.

We fully support the Commission’s efforts to update the framework that informs valuation practices by mutual funds and some ETFs. We commend the Commission for its explicit alignment with the fair value guidance provided by ASC 820 and international guidance, which is a useful and important step.² We also appreciate the Commission’s commitment to a robust vision of Board oversight over the funds that fall within the scope of this issuance and the investment advisors to whom they may delegate their valuation-related tasks. We especially agree with the Commission’s insistence (pp. 6-7) on the importance of getting valuation right, as well as the costs of getting it wrong (i.e., unnecessarily high fees and dissemination of inaccurate information).

In what follows, we offer responses to several of the Commission’s questions that relate to our practical experiences and observations as a securities valuation firm. We hope that the Commission finds our comments useful for its deliberations, and we trust that our slight delay in sending them might be excused, in these extraordinary times.

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¹ <https://www.statista.com/statistics/255518/mutual-fund-assets-held-by-investment-companies-in-the-united-states/>

² Our understanding of the relation between entities is shaped by Dan Palmon, Marietta Peytcheva and Ari Yezegel, “The Accounting Standard-Setting Process in the US: Examination of the SEC-FASB Relationship” in *Group Decision and Negotiation* (2011) 20:165–183.

Question 1: Is this requirement appropriate? Should we further define what risks would need to be considered or provide guidance on the types of valuation risks that a fund may face? Are there additional sources or types of valuation risk that we should address? If so, what sources?

Yes, this requirement is appropriate. We agree with the Commission that all of the following add to risk: structural features, market shocks, unobservable inputs, percentage of assets without trade data, reliance on service providers and “fourth parties,” and valuation methodologies.

In the course of our work, we have also identified the following as significant high risk factors: performance (e.g., changes in credit), market liquidity (for example, 22e-4 liquidity buckets could be used productively), cash flow uncertainty, and market transparency. Only items with readily available trade prices are easiest to price, followed by non-trading items with simple structures that are very similar in their features to items that are trading. As structural features become more complex (embedded options, pooled securities, etc.) and market observability declines, valuation risk rises.

Question 2: Should we require a certain minimum frequency for re-assessing valuation risk (e.g., annually or quarterly)? Should the rule specify types of market events or investment strategy changes that would require a re-assessment of valuation risk? If so, what events or changes should prompt such a review?

Risks should be reassessed quarterly, as a matter of routine, and when market movements meet certain thresholds.

Question 3: Should we provide any further guidance on how valuation risk should be managed?

Stress testing is useful for testing changes in portfolio values given market shifts of 100, 200, or 300 basis points. Further guidance on how to categorize prices by their valuation risk might also be very helpful.

Managing valuation risk requires expertise, as does the interpretation and assessment of both observable and unobservable inputs. For example, Boards and investment advisors should know when a certain security or security type might require additional expertise to value correctly and check. Both should also understand how and why inputs relate to the assignment of price, and how to query pricing services and specialists about those inputs in the course of fulfilling their oversight duties. Appropriate oversight requires a combination of technical knowledge and a sense of the limits of that knowledge.

Question 4: This requirement includes several specified elements, discussed above, relating to the fair value methodologies. Are these elements appropriate? Are there additional elements that commenters believe should be included under this requirement? Should we modify or remove any of the proposed elements? Should we require application of the methodologies in a reasonably consistent manner, or as consistently as possible under the circumstances?

Harvest generally agrees with the requirement. However, accurate understanding of the definition of ‘market quotation’ is exceedingly important in order to mitigate risk successfully. The definition provided on pages 58-9 states that a market quotation “is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date...[and that] evaluated prices are not, by themselves, readily available market quotations. In addition, ‘indications of interest’ and ‘accommodation quotes,’ for example, would not be ‘readily available market quotations.’”

Marks from pricing services and brokers can be (and often are) misconstrued for market quotations (i.e., trade data), and the ‘fourth party’ concept further muddies the waters; it is often unclear whether their prices come from trades, matrix pricing, non-binding broker quotes, or other sources. In order to determine which prices are actually market quotations, it is essential that the Board have access to the ultimate origin of the pricing data. While the vast majority of public equities trade daily, less than 2% of fixed income instruments trade on any given day.³

Question 5: Do commenters believe we should provide additional guidance relating to this requirement? If so, on which elements of the proposed requirement should we provide additional guidance? For example, is the proposed requirement that boards or advisers “select” a methodology sufficiently clear?

We encourage and support guidance that prioritizes and incorporates a consistent process of using the highest-level market information first (trades in exact asset), followed by inputs from comparable items that are trading, and lastly, other approaches that incorporate less observable or unobservable market inputs.

Question 7: Should the rule require particular testing types or minimum testing frequencies? For example, should we require tests to occur at least weekly, monthly, or quarterly? If so, should the frequency required be dependent upon the type of instrument? Should the rule require all funds to use certain types of testing, such as back testing and calibration, at a minimum? Are certain types of methodology testing inappropriate or irrelevant for certain investment types?

Frequency of testing should be based on structural characteristics and the valuation methodology that is used. For example, traded items could be tested with less frequency than those valued with more complex models or valued with inputs that are less or not at all observable. Back-testing and market calibration are crucial; however, when sectors have limited trading, market calibration is not feasible, and some of the more complex instruments simply do not trade. In these situations, it is appropriate to have strong internal controls that include independent price verification and resolution of any unreasonable price variances.

³ <https://www.sifma.org/wp-content/uploads/2017/07/Randy-SnookTestimony-07142017.pdf>

Question 10: Do commenters agree that the proposed rule should require oversight of pricing service providers, if used? Should the rule cover any service providers other than pricing services? If so, which service providers should be included? Should the rule further clarify who qualifies as a pricing service?

The proposal cites that “to obtain valuation information, particularly for thinly traded or more complex assets, pricing services may be used.” (p. 25). We note that pricing services are routinely used for easier-to-value and directly-traded items as well, since this often simply saves time. At Harvest Investments, we provide prices on traded U.S. equities as a free service for all of our clients.

One concern is that many pricing services do not incorporate observable trading in the exact asset for bonds, as they do for their equity counterparts. Instead, they primarily use a matrix pricing system..

When pricing services are used for a) items that have trading in close comparables and/or b) items that are thinly-traded or do not have close comparables, it is essential for there to be transparency concerning the origin of the pricing data: for example, is a price based on a non-binding (and potentially biased) broker quote? Or does it issue from a complex model with one or more observable inputs, or a matrix-derived approximation? Etc.

Information from any third party should be subject to oversight and review of qualifications, expertise in the applicable market sectors, independence, and valuation methodologies (including individual techniques, availability of transparent inputs and assumptions, and other factors, as cited in the proposal).

Question 17: Are key terms used in this aspect of the proposal sufficiently understandable? For example, as stated above, “appropriate documentation to support fair value determinations” under the proposed recordkeeping requirement would include documentation that would be sufficient for a third party to verify the fair value determination. Should we define these or other terms or provide further guidance relating to them?

We think further clarification and elaboration of these terms might prove useful, especially since they bear upon independent third-party verification of fair value.

Question 20: The rule would permit boards to assign the determination of fair value only to an adviser to the fund. Are there other parties to which we should permit boards to assign such determinations? For example, would it be appropriate to allow boards to assign these determinations to pricing vendors or accounting firms? Are there any parties that fund boards currently rely upon to help make fair value determinations that could adequately be relied upon in the same way as a fund adviser? If we do permit other parties to be assigned the determination of fair value under the final rule, what safeguards, if any, should we include to ensure that the determinations of fair value in good faith are conducted consistent with the proposed rule? For example, should we only permit assignment to non-advisers if they have a fiduciary duty to the fund or if they are regulated by the Commission? Why or why not?

No, the Board should only assign the determination of fair value to a party based on experience, expertise, accuracy, and documentation. Some advisors may have more experience in certain asset

classes than others, for example. Any valuation provider should be fully vetted with regard to qualifications, frequency in which they value an asset class, independence, and transparency into the inputs and assumptions used to develop their prices, and the basis for valuation decisions. A policy for review, testing, and challenge should be firmly in place.

Question 34: In light of their importance, should the rule impose specific requirements beyond reporting regarding pricing services? For example, should any pricing services used be explicitly approved by the board? Should there be a required finding or report by the adviser as to pricing services' adequacy and effectiveness?

Pricing services should be approved by boards based on their accuracy, qualifications, frequency in which they price an asset class, and extent of transparency into the valuation, including origin of pricing source, inputs, assumptions, and basis for choosing each. Pricing services should be reviewed and tested for adequacy and effectiveness. Internal controls should cover that testing process with independent pricing verification and other controls.

In order for a Board to oversee the valuation process, the ultimate origin of pricing data must be clear (i.e., does the price come from documented trading, a broker quote, a complex model with one or more observable inputs, or a matrix-derived approximation, etc.). However, we caution that such clarity is much harder to achieve when a price developer or pricing service is several contractual or business steps removed (i.e., fourth party) from the Board and/or its delegated advisor. In such cases, it may be difficult if not impossible to assess the inputs used to construct prices adequately.

The Commission might also suggest that everyone involved with the valuation and oversight functions outlined in the release be AICPA CVFI-certified (Certified in the Valuation of Financial Instruments) or undergo a comparable training in fair-value that will bring them to a similar level of valuation literacy.

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We thank the Commission for its time and attention, and would be happy to assist with its important and timely work in any way we can. Should the Commission have any questions or wish to discuss our comments and suggestions in more detail, we encourage its members to contact our Executive Director of Global Valuations, Susan DuRoss, at 312-823-7051.

Kind regards,

Harvest Investments, Ltd.