Institute for Portfolio Alternatives

July 31, 2020

Vanessa Countryman
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street
Washington, D.C. 20549

Re: Good Faith Determinations of Fair Value
Release No. IC-33845, S7-07-20

Dear Ms. Countryman:

The Institute for Portfolio Alternatives ("***IPA***") appreciates the opportunity to provide comments to the U.S. Securities and Exchange Commission (the "***Commission***") on the Commission's proposed new Rule 2a-5 (the "***Proposed Rule***")[1] under the Investment Company Act of 1940, as amended (the "***Investment Company Act***") that would address valuation practices and the role of the board of directors with respect to the fair value of the investments of a registered investment company or business development company (each, a "***fund***").

IPA appreciates that the Commission has determined to address and provide guidance and regulation of fund valuation for the first time in over 50 years, replacing a patchwork of no-action letters, Commission staff statements, and commentary in Commission releases, such as those provided with respect to amendments in the rule governing money market funds.[2] IPA also supports the objective of the Proposed Rule: to provide updated guidance to reflect the increased role that accounting and auditing developments play in setting fund fair value practices, as well as the growing complexity of valuation and the interplay of the compliance rule in facilitating board oversight of funds, and acknowledging the important role that fund investment advisers play and expertise provided in the fair value determination process.

IPA commends the Commission staff on providing much needed clarity on the ability of a fund's board to assign the fair value determination to the fund's investment adviser, subject to oversight by the board and certain reporting and record-keeping requirements. IPA also applauds the Commission staff for providing a definition of "readily available" in evaluating a market quotation and whether to use "market value" or "fair value." IPA does request clarification on the definition and guidance as to its scope.

However, IPA is concerned that the Proposed Rule could potentially be too prescriptive in requiring certain reports, analyses, and assessments presented by the investment adviser in its reports to the fund's

[1] Good Faith Determinations of Fair Value, SEC Release No. IC-33845, File No. S7-07-20 (the "***Proposing Release***").
[2] *See* Money Market Fund Reform; Amendments to Form PF, SEC Release Nos. 33-9616, IA-3879, IC-31166 (July 23, 2014).

board of directors. IPA agrees with the Commission that the Proposed Rule requirements generally comport with current practices used by funds to value their investments. Complying with the prescriptive aspects of the Proposed Rule, however, would require extensive resources to be expended in evaluating current policies and procedures, without a corresponding benefit to the investing public, since the principles underlying such requirements are generally consistent with current practice and with an investment adviser's affirmative fiduciary duty to the fund and its shareholders of good faith to act in the best interests of the fund and its shareholders.

This letter provides the Commission a brief background of IPA, a discussion of the requirements and scope of the Proposed Rule, and then provides IPA's comments and suggestions regarding the Proposed Rule's requirements.

I. Background of IPA

For over 30 years, the Institute for Portfolio Alternatives ("***IPA***")[3] has raised awareness of portfolio diversifying investment ("***PDI***") products among stakeholders and market participants, including investment professionals, policymakers, and the investing public. The IPA regularly provides substantive input to regulators such as the U.S. Securities and Exchange Commission ([redacted] Financial Industry Regulatory Authority ("***FINRA***"), and it has developed best practice guidelines to standardize industry practice, enhance transparency and performance, and provide consistent metrics.[4] IPA is pleased to have provided meaningful input to both the SEC and FINRA regarding previous rule proposals and initiatives. Furthermore, the IPA is committed to ensuring that all investors have access to real assets and the opportunity to diversify their investment portfolios with PDI products, based on appropriate standards of financial and personal suitability and consistent with the investment goals of the investors.

IPA's membership consists of PDI product sponsors, financial intermediaries such as registered investment advisers and broker-dealers, and industry services providers such as consultants, auditors, and law firms. IPA's mission is to promote PDI products among the investing public, conduct research and provide industry data to its membership, and advocate for their interests to policymakers.

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[3] IPA members include product sponsors, asset management companies, broker-dealers and direct-investment service providers, including major national accounting and law firms and national, regional, and independent broker-dealer firms. Collectively, these members service financial and direct investment assets in virtually all investment categories.

[4] The four guidelines published by the IPA include: (1) Per Share Investment Performance, Measurement & Reporting for Publicly Registered Non-Listed REITs (April 2018), available at http://www.ipa.com/wp-content/uploads/2018/07/IPA-Practice-Guideline-2018.pdf; (2) Non-Listed BDC Practice Guideline (April 2015), available at https://cdn.ymaws.com/ipa.site-ym.com/resource/resmgr/Policy_Advocacy/IPA_Guidelines/Non-listed_BDC_Performance_G.pdf; (3) Valuations of Publicly Registered Non-Listed REITs (April 2013), available at https://cdn.ymaws.com/ipa.site-ym.com/resource/resmgr/Policy_Advocacy/IPA_Guidelines/IPA_Practice_Guideline_-_Val.pdf; and (4) Supplemental Performance Measure for Publicly Registered, Non-Listed REITs: Modified Funds From Operations (November 2010), available at https://c.ymcdn.com/sites/ipa.site-ym.com/resource/resmgr/Policy_Advocacy/IPA_Guidelines/IPA_Practice_Guideline_-_MFF.pdf. These performance guidelines represent widely adopted industry practice.

Among the PDI products that IPA members sponsor are registered investment companies such as tender offer funds and interval funds, and business development companies, all of which will be impacted by the Proposed Rule. In the spirit of collaboration between IPA and policymakers, IPA is pleased to provide you with its thoughts regarding the benefits and considerations of the Proposed Rule.

II. Background of the Proposed Rule

The Proposed Rule provides three areas of focus:

A. Requirements to Determine Fair Values: The Proposed Rule provides that the overall program to determine fair value of a fund's portfolio investments must include:

- Assessing and managing material risks associated with fair value determinations;
- Selecting, applying, and periodically assessing fair value methodologies;
- Testing the appropriateness and accuracy of the fair [redacted]ogies that have been selected;
- Overseeing and evaluating any pricing services used;
- Adopting and implementing policies and procedures reasonably designed to achieve compliance with the first four requirements listed; and
- Maintaining documentation to support fair value determinations, including information regarding the specific methodologies applied and the assumptions and inputs considered.

B. Oversight and Reporting: To the extent the board of directors assigns fair value determinations to the investment adviser, the Proposed Rule would require the board of directors to oversee the investment adviser with respect to its fair value determinations, and the investment adviser would be required to:

- Inform the board in writing of the titles of the persons responsible for determining the fair value of the fund's portfolio holdings, including the particular functions for which they are responsible;
- Reasonably segregate the fair valuation process from the fund's portfolio management;

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- At least quarterly, provide a written report to the fund's board containing an assessment of the adequacy and effectiveness of the investment adviser's processes for determining the fair value of the fund's portfolio investments, including any material changes to the roles or functions of the persons responsible for determining the fair value of the fund's portfolio investments;

- Report to the board of directors in writing promptly on matters (in no event later than three business days after the adviser becomes aware of the matter) associated with the investment adviser's fair valuation processes that materially affect, or could have materially affected, the fair value of the fund's investments; and

- Maintain, in addition to the documentation specified above, the reports and other information provided to the board and a list of the investments whose fair value was determined by the investment adviser.

C. Definition of "Readily Available": Under Section 2(a)(41) of the Investment Company Act, if a market quotation is "readily available" for a portfolio holding, it must be valued at its market value. If market quotations are not readily avai[redacted]s value is its "fair value as determined in good faith by the board." The Proposed Rule would provided that "a market quotation is readily available only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable."

III. IPA Comments

A. Assignment of Fair Value

Proposed Rule 2a-5(b) provides that "[t]he board may choose to assign the fair value determination relating to any or all fund investments to an investment adviser of the fund, which would carry out all of the functions required in paragraphs (a)(1) through (a)(5) of this section, subject to the requirements of this paragraph (b). IPA applauds the Commission staff for provide explicit authorization of board assignment of fair valuation responsibilities. The Proposing Release even acknowledges this explicit authorization is consistent with current practice, stating "typically, boards determine the methodologies used to fair value fund investments, but rely on the adviser for the day-to-day calculation of fair values."[5]

IPA notes, however, that this explicit authorization of assignment of the fair value determination, while welcome, does come with a suite of oversight and periodic reporting, which IPA addresses more fully in Section III.C below.

[5] Proposing Release, *supra* note 1.

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The Proposed Release spends significant time discussing the importance that third-party pricing services provide for the valuation of "thinly traded or complex assets." While the Proposed Rule provides that determining fair value in good faith (whether by the board or the investment adviser) requires the oversight and evaluation of pricing services, it does not provide for the ability of the investment adviser to assign all or a portion of the fair value determinations to a pricing service, similar to the board's ability to assign the day-to-day calculation of fair value to the investment adviser in the Proposed Rule. IPA is not suggesting that the fund have the ability to assign the fair value determination to the investment adviser, which may then assign the fair value determination to a pricing service—far from it. Rather, IPA suggests that the investment adviser have the ability to assign all or a portion of the fair valuation function to a pricing service, subject to the oversight of the investment adviser and ultimately the fund's board.

B. Definition of "Readily Available" Market Quotations

Under the Investment Company Act, fund investments must be fair valued where market quotations are not "readily available." Paragraph (c) of the Proposed Rule would treat a market quotation as "readily available" only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date. The Propose[redacted]so clarify that a quotation is not readily available if it is not reliable. The Proposing Release also states that indications of interest and accommodation quotes would not be considered "readily available market quotations."

The Proposing Release further provides that the Commission "believes that for a fair value methodology to be appropriate under the proposed rule, it must be determined in accordance with GAAP . . . U.S. GAAP requires funds to maximize the use of relevant observable inputs and minimize the use of unobservable inputs. However, under U.S. GAAP there are circumstances where otherwise relevant observable inputs become unreliable. Consistent with this, a quote would be considered unreliable under proposed rule 2a-5 in the same circumstances where it would require adjustment under U.S. GAAP or where U.S. GAAP would require consideration of additional inputs in determining the value of the security."

Thus, the Proposing Release seems to suggest that for purposes of interpreting the Proposed Rule's definition, whether a quotation is "reliable" depends on existing U.S. GAAP. The Proposed Rule implies that market quotations are "not readily available" with the determination under U.S. GAAP that "otherwise relevant observable inputs become unreliable."

While the Proposing Release's gloss on U.S. GAAP is instructive in interpreting the Proposed Rule, it is not part of the Proposed Rule itself and therefore does not carry binding authority, however persuasive. If the framework for determining whether a quotation is indeed U.S. GAAP, IPA recommends that further clarification be provided in the Final Rule.

Finally, IPA notes that until the Proposed Rule, "readily available" was not defined under the Investment Company Act and the rules thereunder. The Proposed Rule states that the definition of "readily available"

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is "[f]or purposes of section 2(a)(41) of the [Investment Company Act]." The term "readily available market quotations" is used elsewhere in the Investment Company Act, for example, in Rule 17a-7(a).[6] Rule 17a-7 is an exemptive rule permitting purchase and sale transactions between affiliated registered investment companies or between a registered investment company and a person that is affiliated with a registered investment company. It provides broad relief from Section 17's wide scope on prohibitions of affiliated transactions, but requires that, in order for entities to avail themselves of the exemptive rule, "[t]he transaction is a purchase and sale for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available."[7]

Reliance on the rule for exemptive relief from Section 17's prohibitions, therefore, turns on whether a market quotation is "readily available," a previously undefined term. IPA recommends further clarification on whether the Proposed Rule's definition of "readily available" is meant to apply only to the determination of fair value required by the Proposed Rule, or whether that definition extends to other usages in the Investment Company Act and rules thereunder.

C. Reporting and Record-Keeping Requirements

As noted above, IPA appreciates the Proposed Rule's goal of "establish[ing [redacted] for boards to effectively oversee the investment adviser" and providing a "consistent framework for fair value and standard of baseline practices across funds."[8] However, IPA submits that the regimented requirements of the Proposed Rule, in the form of the frequency and content of information required to be prepared and presented by the investment adviser to a fund's board of directors, will require a thorough re-evaluation of all funds' valuation policies and procedures for compliance, with no indication that after such an evaluation, such valuation policies and procedures would be meaningfully improved.

The Proposed Rule is the result of at least two years' of Commission staff effort.[9] During that time, the Commission staff conducted "significant outreach" with "funds, investment advisers, audit firms, trade groups, fund directors, and others," culminating in a Proposed Rule that the SEC staff believes is a "standard of baseline practices."[10]

As part of its regulation of the fair valuation policies and procedures of a fund, the Proposed Rule requires an investment adviser, not less than quarterly, provide a written report summarizing not less than six different topics:

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[6] 17 C.F.R. § 270.17a-7.
[7] *Id.* (emphasis added)
[8] Proposing Release, supra note 1.
[9] *See* Dalia Blass, Director, Division of Investment Management, "Keynote Address – ICI Mutual Funds and Investment Management Conference (March 19, 2018), *available at* https://www.sec.gov/news/speech/speech-blass-2018-03-19.
[10] Proposing Release, *supra* note 1.

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- An assessment and management of material valuation risks, including any material conflicts of interest of the investment adviser and any other service provider;
- Any material changes or material deviations from the investment adviser's established fair valuation methodologies;
- The results of any testing of fair valuation methodologies;
- The adequacy of resources allocated to the fair valuation process, including any material changes to the roles or functions of persons involved in the process;
- Any material changes to the investment adviser's process for overseeing pricing services; and
- Any other material changes related to the fair valuation process that the board requests.

First, IPA notes that the Commission has acknowledged that the Proposed Rule's six topic requirements "generally reflect [the Commission staff's] understanding of current practices used by funds to fair value their investments."[11] However, current practice does not mandate reporting each quarter on all six topics unless there is an area that must be addressed by the board. IPA believes that each fund, its investment adviser, and its board of directors will therefore have to conduct an extensive evaluation of both the fund's and the investment adviser's valuation compliance policies and procedures, expending significant resources and expense in doing so, the end result of which may be a process not materially different from what is currently being conducted on a discretionary basis by the investment adviser. However, rather than proposing a principles-based approach to the valuation process, , the Proposed Rule will impose specific procedural requirements on the fund and the investment adviser, which will necessitate a thorough review by the fund's board and the investment adviser. These procedural requirements, and the attendant costs, will be imposed on all funds and investment advisers, even ones that already have robust and compliant valuation policies and procedures. Therefore, we believe the potential benefit of the Proposed Rule to fund shareholders or the investing public generally may be outweighed by the costs associated with complying with such procedural requirements.

IPA submits that the investment adviser and its personnel will be required to expend significant time and resources to produce an extensive written report, the contents of which will likely not materially change from quarter to quarter. While many investment advisers may provide these reports on a periodic basis as a matter of course, it is unlikely that many investment advisers to funds provide a report on quarterly basis addressing topics which have not undergone a material change. Most fund boards of directors already receive voluminous information with respect to valuation. This new report will likely be in addition to, and not in lieu of, the existing valuation presentation being conducted, which could potentially result in a less meaningful and thorough review by the board of directors.

By mandating that an investment adviser to a fund produce these written reports, with specificity as to the required deadlines and content of these reports, the Proposed Rule substitutes a process-driven, rather than substance-based, requirement for valuation, and minimizes the fiduciary duty imposed on investment adviser and the proper oversight function of the board of directors. The investment adviser should be permitted, based on the fiduciary duty imposed on it to the fund and its shareholders by

[11] *Id.*

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operation of law and as a result of the investment advisory contract, to prepare and provide the information that it believes is most relevant for review by the board of directors in its evaluation of the fair valuation function.

While IPA believes the Proposed Rule's list of six topics is a helpful guide on what information should be addressed on an annual basis and as needed periodically, a formalistic requirement to prepare a report on these topics rather than deferring to the fiduciary duties owed by the investment adviser and the board to the fund and its shareholders represents a triumph of process over substance, and could result in an inadvertent deficiency in the implementation of the fund's and the investment adviser's policies and procedures established for compliance with the Proposed Rule.

IPA recommends that, rather than requiring a written report on a quarterly basis addressing these topics, the investment adviser be required only to address those events which have resulted in a material change to these areas based on its discretion, using the six topics as a useful framework to evaluate the valuation process.

If the IPA may be of any assistance, please do not hesitate to contact me or Anya Coverman, IPA's Senior Vice President, Government Affairs and General Counsel, at [redacted].

Sincerely,

Anthony Chereso
President & CEO, Institute for Portfolio Alternatives

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