Dechert LLP

1900 K Street, NW
Washington, DC 20006-1110
+1 202 261 3300 Main
+1 202 261 3333 Fax
www.dechert.com

July 21, 2020

VIA ELECTRONIC DELIVERY

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Investment Company Act Release No. 33845 (File No. S7-07-20); Good Faith Determinations of Fair Value

Dear Ms. Countryman,

We appreciate the opportunity to respond to the request by the U.S. Securities and Exchange Commission ("SEC" or "Commission") for comments regarding the above-referenced release.[1] The Commission proposes new Rule 2a-5 ("Proposed Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"), which 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 (a "fund"). The Proposed Rule would, among other things: (i) set forth detailed requirements for determining fair value in good faith; (ii) establish the conditions under which a market quotation is "readily available" for purposes of the 1940 Act definition of "value"; and (iii) provide that a fund board may assign its fair value determination responsibilities to a fund adviser subject to a number of conditions. We acknowledge the obvious care and thoughtfulness that the Commission put into the preparation of the Proposing Release and appreciate the opportunity to offer comments.

Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and abroad. In the United States, we represent a substantial number of U.S. mutual fund complexes, closed-end funds, exchange-traded funds, business development companies, fund boards, fund independent directors, fund advisers and fund service providers. In developing these comments, we have drawn on our extensive experience in the financial services industry generally. Although we have discussed certain matters addressed in the Proposing Release with some of our clients, the comments that follow reflect only the views

1 *See* Good Faith Determinations of Fair Value, Investment Company Act Release No. 33845, 85 Fed. Reg. 28734 (May 13, 2020) ("Proposing Release").

of a group of attorneys in our financial services practice, and do not necessarily reflect the views of our clients, other members of our financial services group or the firm generally.

We support the Commission's goal of providing a framework for appropriate fair valuation practices and in promoting structures that permit fund boards to engage in effective oversight of the fund complexes they serve. However, we believe that the Proposed Rule in its current form is too prescriptive and does not enable funds, their boards and service providers to effectively use the range of appropriate and effective fair valuation practices employed by funds today. Accordingly, we suggest that the Commission restructure the Proposed Rule as a non-exclusive safe harbor or, at a minimum, make the rule less prescriptive. We believe that such an approach would help achieve the Commission's objectives and would be more effective and less costly than the prescriptive, "one-size-fits-all" approach of the Proposed Rule. We discuss these and certain other suggested enhancements to the Proposed Rule below.

I. FRAMEWORK FOR PROPOSED RULE 2A-5; SAFE HARBOR

Under Section 2(a)(41) of the 1940 Act and Rule 2a-4 thereunder, securities for which market quotations are not ready available are required to be valued at "fair value as determined in good faith by the board of directors." The Proposed Rule would provide that determination of fair value in good faith *requires* adherence to six prescriptive steps, some with multiple sub-parts. This prescriptive framework is inherently inconsistent with the notion of a "good faith" statutory standard, which is designed to accommodate various relevant facts and circumstances and a range of different practices.[2] It is also inconsistent with state law fiduciary duty concepts, and in particular the business judgment rule, which provides that directors will not be held liable for their decisions where they act in good faith, remain reasonably informed, and reasonably believe that their actions are in the best interests of the fund and its shareholders.[3] The structure of the Proposed

---

2 *See, e.g.,* Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118, 35 Fed. Reg. 19988 (Dec. 23, 1970) ("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."); Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC (Dec. 8, 1999) ("1999 Letter") (acknowledging that fair value pricing is not "an inelastic concept").

3 The business judgment rule is a prominent example of the flexibility embedded in a good faith standard. *See* Orman v. Cullman, 794 A.2d 5, 19-20 (Del. Ch. 2002) ("The rule '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.' Therefore, the judgment of a properly functioning board will not be second-guessed and '[a]bsent an abuse of discretion, that judgment will be respected by the courts.'"); *see* Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1125 (Del. Ch. 1990) ("[I]nquiries concerning fiduciary duties are

Rule leaves open the possibility that a failure to satisfy one or more component obligations under the Proposed Rule – either knowingly or inadvertently – could result in the inference that a fund board is failing to satisfy its statutory obligation under Section 2(a)(41) regardless of the accuracy of valuations determined thereby.

We recognize and acknowledge the benefits to fair value determinations that these steps could represent. This compliance framework may reduce the risks of inaccurate fair valuations, much like the compliance framework established under Rule 22e-4 under the 1940 Act ("Liquidity Risk Management Rule") may reduce the risks of a fund not being able to meet redemption requests without significant dilution of remaining investors' interests, or the compliance framework set forth under proposed Rule 18f-4 under the 1940 Act ("Proposed Derivatives Risk Management Rule") may reduce the risks associated with a fund's derivatives transactions.[4] Unlike the Liquidity Risk Management Rule and the Proposed Derivatives Risk Management Rule, however, the Proposed Rule seeks to give meaning and guidance to a statutory phrase and mandate in addition to creating a compliance regime designed to manage risk.[5] The Proposed Rule is not just a "Valuation Risk Management Rule," and its structure should not mimic the structure of other risk management rules under the 1940 Act.

---

inherently particularized and contextual. It is probably not possible to work out rules that will be perfectly predictive of future cases involving claimed impediments to the shareholder vote. It is sufficient to express a reasoned judgment on the facts presented.").

4 *See* Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315, 81 Fed. Reg. 82142 (Nov. 18, 2016) ("Liquidity Rule Adopting Release"); Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, Investment Company Act Release No. 33704, 85 Fed. Reg. 4446 (Jan. 24, 2020) ("Derivatives Rule Proposing Release").

5 *Compare* Proposing Release at 28737 ("The proposed rule would provide requirements for determining fair value in good faith with respect to a fund for purposes of section 2(a)(41) of the Act and rule 2a-4 thereunder.") *with* Liquidity Rule Adopting Release at 82144 ("[T]hese reforms are designed to provide investors with increased protection regarding how liquidity in their open-end funds is managed, thereby reducing the risk that funds will be unable to meet redemption or other legal obligations, and mitigating dilution of the interests of fund shareholders.") and Derivatives Rule Proposing Release at 4448 ("We are re-proposing rule 18f-4, which is designed to address the investor protection purposes and concerns underlying section 18 and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions and certain other transactions.").

Rather than structuring the Proposed Rule in the style of a risk management rule, we respectfully submit that it would be more appropriate to structure the rule as a non-exclusive safe harbor that provides one means – but not the only approach – for satisfying the statutory standard.

Consider, for example, Section 17(e)(2) of the 1940 Act and Rule 17e-1 thereunder. Section 17(e)(2) makes it unlawful for any first- or second-tier affiliate of a registered investment company, acting as broker, in connection with the sale of securities to or by such registered company, to receive from any source a commission, fee, or other remuneration for effecting such transaction that exceeds, if the sale is effected on a securities exchange, "the usual and customary broker's commission." Rule 17e-1 gives meaning and guidance to this statutory phrase by establishing a non-exclusive safe harbor – remuneration is *deemed* not to exceed "the usual and customary broker's commission" for purposes of Section 17(e)(2)(A) if an enumerated set of requirements are satisfied, without foreclosing other alternatives for complying with the statutory requirements of Section 17(e)(2). As another example, consider Regulation D under the Securities Act of 1933, as amended (the "Securities Act"), which provides meaning and guidance to what is meant by "transactions by an issuer not involving any public offering," thereby providing a non-exclusive means of satisfying the private securities offering exemption in Section 4(a)(2) of the Securities Act.[6]

In the same way, we submit that, rather than seeking to create a valuation risk management regime (and attendant strict liability for any deviation from that regime), the Commission should give meaning and guidance to the statutory phrase "fair value as determined in good faith" in Section 2(a)(41). It should do so by creating a rule that *deems* fair value determined in accordance with an enumerated set of conditions as being "fair value determined in good faith" for purposes of Section 2(a)(41) of the 1940 Act and Rule 2a-4 thereunder. Fair values not determined precisely in accordance with every element of such an enumerated set of conditions should not automatically subject funds or their boards to potential liability for statutory violations (regardless of whether any valuation failure actually occurs). Rather, there should be no presumption created by Rule 2a-5 concerning whether a fair value determined in accordance with a system that diverges from the rule's enumerated conditions constitutes a "fair value determined in good faith."[7] Of course, given

---

[6] *See also* Rule 3a-4 under the 1940 Act, which provides a non-exclusive safe harbor from the definition of "investment company." As the Note to Rule 3a-4 explains, "This section is a nonexclusive safe harbor from the definition of investment company for programs that provide discretionary investment advisory services to clients. . . . The section is not intended, however, to create any presumption about a program that is not organized and operated in the manner contemplated by the section."

[7] Such an approach would also be consistent with the state law duties directors owe to a fund and, in particular, the business judgment rule. *See supra*, note 3.

the certainty provided by compliance with a safe harbor, we expect that most funds would comply with the requirements of the rule, thereby achieving the Commission's objective of establishing a "minimum, consistent framework" and "standard of baseline practices across funds" with respect to fair value determinations.[8]

If a final Rule 2a-5 is not structured as a safe harbor, we believe it is important that the rule be less prescriptive than proposed, to allow funds greater flexibility to implement valuation practices that are appropriately tailored to their facts and circumstances, as they do today in good faith in accordance with the statutory requirements. We have suggested certain changes in Sections II and III to make the Proposed Rule less prescriptive and conform more closely to current practices. While we believe the Commission should consider these changes whether or not Rule 2a-5 is ultimately structured as a safe harbor, the need for these changes takes on much greater significance to the extent it is not so structured.

II. FAIR VALUE DETERMINATION

Under the Proposed Rule, determination of fair value in good faith would require the following: (i) periodic assessment of material valuation risks; (ii) establishment and application of fair valuation methodologies, taking into account the fund's valuation risks; (iii) testing of fair valuation methodologies; (iv) evaluation of pricing services, if used; (v) adoption and implementation of written policies and procedures reasonably designed to achieve compliance with the four preceding requirements; and (vi) maintenance of certain specified records. Given the definition of "readily available market quotations" under the Proposed Rule, these requirements would apply to a broad range of investments, including most debt investments.

In general, we believe that the prescriptiveness of the requirements around establishment and application of fair valuation methodologies, testing of fair valuation methodologies, and evaluation of pricing services (specifically, criteria for initiating price challenges) does not account for the burdens that it would introduce to an already complex valuation process, or the flexibility funds need to effect fair valuations in good faith in light of circumstances that exist at the time. While valuation requires precise calculation, it also requires expert judgment, and funds should be permitted to adopt policies and procedures that reflect these dual needs. Accordingly, we believe that a final rule should call for less specificity in these areas, as discussed in greater detail below.

In addition, we note that the Proposed Rule does not distinguish between valuations provided by pricing services and fair valuations determined by a fund through its (or its adviser's) own methodologies. We believe that a final rule should allow funds to adopt fair valuation

[8] Proposing Release at 28737.

methodologies that distinguish between different types of fair valuations based, for example, on the sources used for such valuations – similar to the three-tiered approach used in the accounting guidance. We agree with the requirement to establish a process for approving, monitoring, and evaluating pricing services,[9] but believe that the establishment of such a process obviates the need to apply certain other requirements of the Proposed Rule to pricing service-provided prices. The use of prices provided by pricing services presents different conflicts than other methods of fair valuation, which in our view can be appropriately addressed through due diligence and price challenge processes and controls. Accordingly, we believe that the application of the full scope of the Proposed Rule's requirements to pricing service-provided prices would result in significant costs with little benefit.

A. Require Establishment of How Fair Valuations will be Determined, Not Selection and Application of Methodologies, Inputs and Assumptions

Under the Proposed Rule, determining fair value in good faith would require selecting and applying in a consistent manner an appropriate methodology or methodologies for determining (and calculating) the fair value of fund investments, including specifying: (i) the key inputs and assumptions specific to each asset class or portfolio holding; and (ii) which methodologies apply to new types of fund investments in which a fund intends to invest.[10] The Commission indicated that the requirement to specify key inputs and assumptions means more than referring to specific fair valuation models.[11] The Commission also indicated an expectation that, prior to investment in a new type of investment, the board or adviser (as applicable) should address whether fair valuation will be necessary, and if so, with what frequency (*i.e.*, occasionally or always), and should identify

9 Although we agree with the proposed requirement, we urge the Commission to clarify that neither the Proposed Rule nor guidance in the Proposing Release is intended to impose new obligations specifically on fund chief compliance officers ("CCOs") or compliance departments. In this regard, we believe that statements such as "boards should consider the adviser's compliance capabilities that support the fund's fair value processes, and the oversight and financial resources made available to the CCO relating to fair value" could be implied to refer to a newly-imposed, larger role for fund CCOs or compliance departments in the context of fair valuation generally or oversight of pricing services in particular. *See* Proposing Release at 28743.

10 Proposed Rule 2a-5(a)(2)(i).

11 Proposing Release at 28739 n.45 ("Regarding the key inputs and assumptions specific to each asset class or portfolio holding, it would not be sufficient, for example, to simply state that private equity investments are valued using a discounted cash flow model, or that options are valued using a Black-Scholes model, without providing any additional detail on the specific qualitative and quantitative factors to be considered, the sources of the methodology's inputs and assumptions, and a description of how the calculation is to be performed (which may, but need not necessarily, take the form of a formula).").

information sources for inputs to the pricing process.[12] Finally, the Proposed Rule's required written policies and procedures would need to address these requirements.[13]

We are concerned that the Proposed Rule contemplates more specificity with respect to methodologies and inputs than is practicable or beneficial in advance of a fair value event. The investment of complex instruments may involve various inputs or alternative approaches based on the facts and circumstances, and it may not be possible to foresee and document all of these in advance. In addition, the Proposed Rule's requirements to determine specific fair valuation methodologies in advance of investing in new types of fund investments may introduce roadblocks to taking advantage of new investment opportunities for the benefit of fund shareholders. Furthermore, in the case of prices supplied by pricing vendors, the fund does not establish the particular methodologies, inputs, and assumptions, but instead reviews them as part of its due diligence process.

We respectfully submit that a more workable approach would be for a final Rule 2a-5 to require that funds' written policies and procedures establish *how* fair valuation determinations could be made for portfolio investments. This would permit a fund's approach to fair valuation to evolve with markets and investment products while remaining faithful to the principles and processes described in its written policies and procedures. It would also avoid potential delays in taking advantage of new investment opportunities for the benefit of fund shareholders in order for written procedure updates to be made and approved.

In addition, although the Proposed Rule would not require that a single fair valuation methodology be used in all cases, the Proposing Release indicates that "any methodologies selected [must] be applied consistently to the asset classes for which they are relevant."[14] We believe that this is potentially too limiting, particularly in the absence of guidance regarding the meaning of "asset class" in this context. Depending on the particular facts and circumstances, it may be appropriate

---

12 Proposing Release at 28739 n.49 ("For example, the board or adviser, as applicable, generally should address, prior to the fund's investing in a new type of investment, whether readily available market quotations will be used or if the investment may need to be fair valued on occasion or at all times. For certain types of investments, it should be clear that the asset will require a fair value at all times. For others, however, market quotations may sometimes be readily available and sometimes not, so that periodically a fair value will need to be determined. The board or adviser generally should seek to identify sources of price inputs before the fund invests in such asset classes, if possible, in addition to determining an appropriate fair value methodology, and generally should document these decisions.").

13 *See* Proposed Rule 2a-5(a)(5).

14 Proposing Release at 28739 n.46.

for investments in the same asset class to be valued, in good faith, using different methodologies. Indeed, the SEC staff previously recognized the flexibility permitted in making fair value determinations in good faith, stating as follows in the 1999 Letter:

> We believe that "good faith" is a flexible concept that can accommodate many different considerations, including the incorporation of a variety of sources of information. Finally, we believe that the specific actions that a mutual fund 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.[15]

Funds and advisers regularly rely on this guidance in developing valuation policies and procedures appropriate for particular funds and asset classes. Accordingly, as part of the adoption of a final Rule 2a-5, we encourage the Commission to reiterate these prior statements by the SEC staff acknowledging the flexibility of the good faith standard and differences in fair valuations among funds.

B. Allow Flexibility with respect to Testing Approaches and Frequency

The Proposed Rule would require "[t]esting the appropriateness and accuracy of the fair value methodologies that have been selected, including identifying the testing methods to be used and the minimum frequency with which such testing methods are used." This proposed requirement is intended to support the proposed requirement discussed above to periodically review the appropriateness and accuracy of selected fair valuation methodologies and make necessary adjustments. The Proposing Release discusses two types of testing – "calibration" and "back-testing."

As in the case of methodologies, we believe the final rule should reflect greater recognition that testing approaches and frequency will vary based on facts and circumstances, may change over time, and may involve reliance on pricing services. Accordingly, we suggest that a final rule provide for testing at such frequency and through such methods or parties as is reasonable and appropriate by the fund or its assignee, subject to board oversight. In addition, in a final rule or adopting release, we do not believe the Commission should require (or overemphasize reliance on) particular methods of testing, which may not be the most effective approach depending on the asset class of an investment or current market conditions.

---

15 1999 Letter.

C. Require a Process, rather than Specific Criteria, for Price Challenges

The Proposed Rule would require establishment of "criteria for initiating price challenges." We believe that this overestimates both the significance of price challenges and the potential conflicts of interest associated therewith. It is a normal part of the valuation process for an adviser to question a pricing service about the basis for a price, an indication of the careful attention given by funds and advisers to valuations provided by pricing services. The determination to do so involves the exercise of judgment in part based on market conditions that exist at the time. Accordingly, we believe a less rigid requirement, such as to establish a "process for initiating price challenges," would better reflect the existing dynamic between advisers and pricing services. Such an approach would allow funds to respond appropriately to facts and circumstances that warrant – or do not warrant – price challenges while still addressing potential conflicts of interest involved in the process.

D. Clarify Recordkeeping Requirements, Particularly for Pricing Service-Supplied Prices

The recordkeeping provisions of the Proposed Rule would include requirements to maintain appropriate documentation to support fair value determinations, including information regarding the specific methodologies applied and the assumptions and inputs considered when making fair value determinations, as well as any necessary or appropriate adjustments in methodologies. The Commission explained that this requirement "would include documentation that would be sufficient for a third party to verify the fair value determination" and asked whether further guidance should be provided.[16]

Particularly if applied to valuations provided by pricing services, we believe that these recordkeeping requirements would be extremely burdensome and costly, arguably impossible to force on pricing services, and provide limited benefit given the due diligence that currently should be undertaken, and under the Proposed Rule would be required, with respect to the pricing service's methodologies. Accordingly, we believe that as part of a final Rule 2a-5 the Commission should clarify that maintenance of records relating to the pricing service oversight requirements of the Proposed Rule, together with a record of prices received and the rationale for any adjustments thereto, is sufficient as it relates to recordkeeping for valuations supplied by pricing services.

---

16 Proposing Release at 28741-42 ("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?").

III. PERFORMANCE OF FAIR VALUE DETERMINATIONS

A. The Commission Should Clarify the Meaning of the Term "Assign" for Purposes of any Final Rulemaking

The Proposed Rule would expressly place fair valuation responsibilities on a fund's board as required under the language of Section 2(a)(41) of the 1940 Act, but would permit the board to *assign* those responsibilities (subject to ongoing oversight) to an investment adviser of the fund. It is unclear from the Proposing Release how the SEC's choice of the term "assign" to refer to a fund board's decision to vest responsibility for determining fair valuations in one or more investment advisers is intended to shape a fund board's responsibilities and liabilities under the rule. The concept of an assignment derives from contract and property law and applies to rights and interests, not responsibilities. The use of the term "assignment" could be read to mean that a board that assigns responsibility to an investment adviser would be responsible only for taking the steps required under any final rulemaking and general oversight in accordance with its fiduciary duties, or could instead mean that the board would still retain responsibility for all aspects of valuation (including errors or omissions of an assignee). With respect to the operation of the rule, this distinction could have potentially meaningful implications.

The need for clarity takes on particular significance given the language used by the SEC to describe the board's oversight role in the Proposing Release. In the Proposing Release, the SEC articulated high-level expectations regarding the nature, scope and tone of board oversight: "[b]oards should approach their oversight of fair value … with a skeptical and objective view"; "effective oversight cannot be a passive activity"; and "[t]he board should view oversight as an iterative process and seek to identify potential issues and opportunities to improve the fund's fair value processes."[17] The SEC also stated that "[b]oards should probe the appropriateness of the adviser's fair value processes."[18] These statements suggest substantial board involvement in fair valuation processes.

In light of these statements, we recommend that, as part of any final rulemaking, the SEC clarify how the term "assign" for purposes of Rule 2a-5 is intended to be interpreted as it relates to board responsibilities and liabilities. In this regard, it is our recommendation that where an assignment is made in compliance with Rule 2a-5 and the fund board exercises reasonable, good faith oversight over an assignee, the fund board should not be liable for errors or omissions of the assignee in the fair value process, similar to the standard under the business judgment rule.[19] Absent such clarity, we believe that the ability to assign fair valuation responsibilities is significantly less meaningful

---

17 Proposing Release at 28743.

18 Proposing Release at 28743.

19 *See supra*, note 3.

for fund directors, as it provides them little more certainty as to their responsibilities and liabilities than exists under the current regulatory framework.

B. The Scope of Permissible Assignees Should be Expanded

Under the current regulatory framework, a fund board may not delegate the *determination* of fair value under Section 2(a)(41) of the 1940 Act but may delegate the task of *calculating* fair values, provided that the board satisfies itself that the resulting fair valuations are fair. Although the Proposed Rule recognizes the role of investment advisers in the fair value processes currently used by fund complexes, it does not address the various organizational structures that exist today and the role of fund administrators or other parties that may currently be engaged by the board to assist with valuation matters.

In our experience representing fund complexes that employ a variety of fair valuation processes, the decision by a fund board to delegate day-to-day fair valuation tasks (such as calculating fair values pursuant to board-approved policies and procedures) to a fund's investment adviser or other service provider (such as an affiliated administrator) has not impacted the quality of fair values derived. Accordingly, we recommend that the SEC, as part of any final rulemaking, expressly permit assignment of fair valuation responsibilities to: (i) an investment adviser of a fund;[20] (ii) an affiliated person (within the meaning of Section 2(a)(3) of the 1940 Act) of an investment adviser of a fund; and (iii) for an internally-managed fund, one or more officers or employees of the fund (each a "Permissible Assignee"). We further recommend that the Commission allow a Permissible Assignee to allocate one or more of its fair valuation responsibilities to another party (including those that are not Permissible Assignees under the rule), subject to the supervision of the Permissible Assignee. Any such discretion to allocate specific fair value responsibilities to the entity or entities best positioned to carry out such responsibilities would not only help to facilitate the continued determination of reliable fair values but also recodify existing discretion already afforded to fund boards in carrying out their statutory obligation under Section 2(a)(41).

By providing this discretion as part of any final rulemaking, the SEC would recognize the role that fund service providers have historically played in calculating reliable fair values while providing a fund board with the means through which to exercise effective oversight over the services provided. In addition, permitting the allocation of fair value responsibilities in this manner would result in the least disruption to existing fair value determination processes – processes which have not been

[20] We ask the Commission to clarify that an investment adviser can be assigned valuation responsibilities pursuant to an administration or other agreement, to accommodate existing arrangements whereby an investment adviser provides valuation services in its capacity as fund administrator. We believe that this is permitted under the rule text as drafted, but request the Commission clarify this point for the avoidance of any doubt.

identified as having led to unreliable fair values – and expenditure of fund and board resources to restructure such processes to comply with the new rule requirements.

C. The Prescriptive, Detailed Approach to Board Reporting Reflected in the Proposed Rule is Inconsistent with an Oversight Role and Should be Replaced with a Principles-Based Reporting Regime

We recommend that, as part of any final rulemaking, the SEC replace the Periodic and Prompt Reporting Conditions (each defined below) with a principles-based regime for board reporting related to fair value determination-related matters.

Under the Proposed Rule, a fund board that assigns fair value determination responsibilities to an investment adviser of the fund would be deemed to satisfy its statutory obligation under Section 2(a)(41) under the 1940 Act by, among other things, *overseeing* the fair value determinations conducted by the investment adviser. To this point, the Commission stated that a fund board should take care to: (i) monitor for potential conflicts of interest;[21] (ii) probe the appropriateness of the adviser's fair value processes;[22] and (iii) take care in considering the "type, content, and frequency of reports that they receive."[23] Importantly, the Commission stated that a fund board may not be deemed to satisfy its oversight duty if it becomes aware of a material matter but does not inquire about such matter and take reasonable steps to ensure it is addressed. In support of a fund board's oversight obligations in the event of a fair value determination assignment, the Proposed Rule would require, among other conditions, that the investment adviser provide (i) periodic reporting and written assessment of the fair valuation process's adequacy and effectiveness (the "Periodic

---

21 For example, the Commission stated that (i) an adviser to whom fair value determination responsibilities have been assigned has "an incentive to improperly value fund assets in order to increase fees, improve or smooth reported returns, or comply with the fund's investment policies and restrictions" and (ii) other service providers may have the incentive, or otherwise be subject to pressures, to "provide pricing estimates that are favorable to the adviser." Proposing Release at 28743.

22 This may include, among other things, periodically reviewing (i) the "financial resources, technology, staff, and expertise of the assigned adviser," (ii) the "reasonableness of the adviser's reliance on other fund service providers," and (iii) the adviser's compliance capabilities. Proposing Release at 28743.

23 Similar to the adopting release for Rule 38a-1 under the 1940 Act, the Proposing Release expressly states that a fund board "can reasonably rely on the information provided to it in summaries and other materials provided by the adviser and other service providers in conducting its oversight" but that the board must "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." Proposing Release at 28743.

Dechert LLP

Reporting Condition") related to six core areas and (ii) prompt written reporting of matters associated with the fair valuation process that materially affect, or could have materially affected, the fair value of portfolio investments (the "Prompt Reporting Condition"). With respect to the Periodic Reporting Condition, the Proposing Release also includes a list of additional materials that a fund board may consider requesting, "if relevant."[24]

As proposed, the Periodic and Prompt Reporting Conditions would burden fund boards with a volume of fair value determination-related information that is inconsistent with the SEC's core objective that a fund board exercise *oversight* responsibilities in the event of a Rule 2a-5 assignment and would impose significant costs on fund sponsors without enumerating a concrete benefit or indication that existing fair value processes have resulted in unreliable fair values being assigned to fund portfolio holdings. In addition, the vague standard under the Prompt Reporting Condition is inconsistent with the Commission's decision not to propose a principles-based approach on the view that it creates potential uncertainty.[25]

1. The Periodic and Prompt Reporting Conditions are Inconsistent with an Oversight Role

While we appreciate that the Commission's purpose in proposing the Periodic and Prompt Reporting Conditions is to ensure that a fund board "has sufficient information to conduct this oversight,"[26] our experience advising funds and boards regarding the implementation of SEC regulatory requirements leads us to believe that the Periodic and Prompt Reporting Conditions would have the unintended effect of causing fund boards to be actively engaged in day-to-day fair valuation matters. Particularly when coupled with the fact that the Proposed Rule is not structured as a safe harbor for compliance with a fund board's statutory obligation under Section 2(a)(41), we would expect most, if not all, fund boards to believe it imperative to take an extremely expansive

---

24 For example, the Proposing Release indicates that a board also may request: (i) summaries of adviser price challenges; (ii) calibration and back-testing data regarding directional closeness and accuracy of fair values and next actual market prices; (iii) information regarding stale priced securities; (iv) information regarding internal tolerance threshold breaches; (v) narrative summaries of pricing errors; (vi) reports on pricing vendor due diligence reviews; (vii) results of independent auditor assessments of the valuation process; (viii) information regarding trends in portfolio holdings subject to fair valuation; and (ix) reports on the securities for which fair valuations were determined based on broker-provided information. Proposing Release at 28745-46.

25 Proposing Release at 28761 (discussing the determination not to propose a more principles-based approach and noting that "under such an approach funds could be less certain on how to comply with the proposed rule").

26 Proposing Release at 28743.

view of both the nature and quality of information required to be received pursuant to the Periodic and Prompt Reporting Conditions to protect themselves from potential liability or second guessing by external parties. This dynamic could be expected because, among other reasons, the structure of the Proposed Rule leaves open the possibility that a failure to satisfy one or more component obligations of the Proposed Rule – either knowingly or inadvertently – could result in the fund board failing to satisfy its statutory obligation under Section 2(a)(41).

In addition, the Prompt Reporting Condition standard is vague and overly broad, and therefore would be difficult to apply in practice. We expect it would result in every error effectively becoming a prompt reporting event, thereby triggering prompt reporting of matters that do not in fact require immediate board attention. As a result, fund boards would receive substantially more information on a routine basis under the Proposed Rule than such fund boards typically receive under the current valuation framework. The receipt of such information creates two practical challenges for fund boards.

First, as the Commission is aware, fund boards do not receive information regarding valuation practices in isolation: such information is provided as part of a broad package of materials on a wide variety of topics. In fact, the SEC staff has previously recognized that the volume of board responsibilities – and, we believe by extension, the volume of board reporting associated with such responsibilities – detract from a fund board's ability to effectively engage in oversight activities.[27]

[27] *See e.g.*, Andrew J. Donohue, Keynote Address at the Practicing Law Institute Investment Management Institute 2007 (Apr. 12, 2007), available at https://www.sec.gov/news/speech/2007/spch041207ajd.htm ("With the increase of regulations requiring action by fund boards, we risk overburdening directors and detracting them from their fundamental activities . . . I am reaching out to fund directors by attending industry meetings they attend and by attending fund board meetings. Through this effort I hope to learn the regulations and guidance that directors believe should be amended or revised that would make a big impact on their work"); Dalia Blass, Keynote Address: Investment Company Institute Securities Law Developments Conference (Dec. 7, 2017), available at https://www.sec.gov/news/speech/blass-keynote-ici-securities-law-developments-conference-2017 (explaining that the SEC's Board Outreach Initiative is "aimed at reviewing and reevaluating what we ask fund boards to do" and that while the importance of the board has not changed over time, "the list of [a fund board's] responsibilities has grown significantly in 77 years."); Dalia Blass, Remarks at the Independent Directors Council 2018 Fund Directors Conference, (Oct. 16, 2018), available at https://www.sec.gov/news/speech/speech-blass-101618 (explaining that the Board Outreach Initiative was intended to "review and reevaluate what [the SEC] asks fund boards to do . . . . [to] enable boards to focus on the inquiries that serve investors best" and highlighting that "[d]irectors see themselves as adding value in different ways from management – they are there to hold management accountable but not to delve into the day-to-day running of the fund"). *See also* Burks v. Lasker, 441 U.S. 471, 484 (1979) (quoting Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir.

As a result, the SEC staff's Board Outreach Initiative was designed to, and has resulted in steps being taken to, reduce the responsibilities required to be directly carried out by fund boards over time. However, for those responsibilities that do remain with a fund board, board members are often presumed to have fully internalized all information received and made appropriate inquiries. Therefore, given the importance of effective fair value processes to a fund complex and expectations of regulatory scrutiny in this area following the adoption of any final rulemaking, the required reporting would unduly burden boards with new reports and, as a result, may divert board attention from other important oversight matters. This result would be contrary to the SEC staff's stated goal for the Board Outreach Initiative and, more fundamentally, would further constrain board oversight capacity in other areas. Moreover, the amount of information could serve to obscure, rather than highlight, significant valuation matters for the board.

Second, given the volume of information that would be provided to fund boards under the Proposed Rule, there may be an expectation – self-imposed by fund boards or from external actors – that fund board members take action based on the information received. Among other things, this could result from fund boards' assessment of the statement from the Proposing Release indicating that when a fund board:

> becomes aware of material matters (whether the board identifies the matter itself or the fund's CCO or adviser or another party identifies the issue), we believe that in fulfilling its oversight duty the board must inquire about such matters and *take reasonable steps to see that they are addressed.*[28]

When coupled with the fact that the Proposed Rule is not structured as a safe harbor, it is likely that fund boards would act by requiring heightened levels of reporting on fair value determination-related matters, identifying a greater number of matters requiring management attention than would otherwise be necessary. For example, although the Proposing Release indicates that a fund board can rely on summary information, the structure of the Proposed Rule could lead fund boards to request detailed trade-by-trade or other day-to-day operational data with respect to the fair value determination process to avoid being labelled as having received inadequate information to carry out its oversight responsibilities and/or not having taken reasonable steps to see that issues are being addressed. This would be the opposite of the SEC's intended result – both with respect to the Board Outreach Initiative and the Proposed Rule.

1977) for the proposition that Congress structured the 1940 Act "to place the unaffiliated directors in role of 'independent watchdogs'" and noting that the unaffiliated directors would "'furnish an independent check upon the management' of investment companies.").

28 Proposing Release at 28743 (emphasis added).

2. The Periodic and Prompt Reporting Conditions Should be Replaced with a Principles-Based Reporting Regime

Although we support the adoption of a new rule that allows a fund board to assign fair value determination responsibilities to one or more investment advisers subject to ongoing oversight, we believe that the Proposed Rule would impose an overly prescriptive and rigid approach to fair value determination oversight that neither differentiates among the spectrum of funds that currently operate nor serves to achieve the SEC's stated policy objective to promote effective board oversight. As a result, we believe that a principles-based approach to fair value determination oversight would be more effective and much less costly for most fund complexes than the prescriptive, "one-size-fits-all" approach of the Proposed Rule.

We are concerned that the Proposed Rule fails to take into account the dynamic, flexible valuation processes – including with respect to board reporting – that have been implemented by many fund complexes and have historically resulted in reliable fair values. We believe that it is illustrative that the Proposing Release does not make the claim that existing oversight processes with respect to fair value calculations are inadequate. Instead, the Proposing Release highlights the importance of "establish[ing] a framework for boards to effectively oversee the investment adviser"[29] in the event of a permitted assignment of responsibilities under the Proposed Rule. However, fund complexes have already implemented comprehensive processes with respect to fair value calculation oversight.[30] Thus, we believe that the highly prescriptive approach taken in the Periodic and Prompt Reporting Conditions is unnecessary. As the impetus of the Proposed Rule is, in part, related to the impact of regulatory developments that "fundamentally altered" how funds and fund boards address fair valuation since Accounting Series Release 113 and Accounting Series Release 118[31] were issued, we urge the SEC to revisit the "one-size-fits-all" approach of the Proposed Rule and replace it with a more flexible, principles-based approach that appreciates the variation over time with respect to fair valuation processes generally, the specific fair valuation processes utilized

---

29 Proposing Release at 28737.

30 *See, e.g.*, Deloitte, *Fair Valuation Pricing Survey: Executive Summary* (17th ed. Sept. 18, 2019), *available at* https://www2.deloitte.com/us/en/insights/industry/financial-services/fair-valuation-pricing-survey.html (discussing oversight tools utilized by fund boards, including advance specification of when boards must be notified of valuation matters; "ad hoc" inquiries; and risk-based valuation reporting).

31 Statement Regarding "Restricted Securities," Accounting Series Release No. 113, 35 Fed. Reg. 19989 (Oct. 21, 1969); Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118, 35 Fed. Reg. 19988 (Dec. 23, 1970).

by individual fund complexes in particular, and the specific relationship between a fund board and the fund complex which such board oversees.

We recommend that the SEC adopt a principles-based approach that, similar to that currently in effect for contract reviews under Section 15(c) of the 1940 Act, would require a fund board to request and review, and the adviser[32] to provide, such information at such frequency as may reasonably be necessary to evaluate the adviser's exercise of its assigned responsibilities. Such an approach would provide fund boards with the discretion to develop and implement, in their exercise of judgment, a framework for overseeing the fair value determination process in the event of an assignment of such responsibilities to one or more investment advisers of the fund(s). This structure would allow fund boards to tailor the fair value reporting they receive over time to reflect both the specific conflicts of interest and other matters presented by the fair value determination process actually used while also allowing such oversight processes to be dynamic and responsive to future changes in requirements related to, and processes for carrying out, fair value determinations. Notably, this very approach has worked for fund boards for decades, and the SEC has not identified any problems to date with allowing boards to determine the amount of information they receive regarding valuation.

We similarly recommend that the SEC consider the procedural framework of Rule 38a-1 under the 1940 Act for requiring a fund board to implement processes for overseeing fair value determinations in the event such responsibilities are assigned to one or more investment advisers. In adopting Rule 38a-1 under the 1940 Act, the SEC noted that the rule "provides fund complexes with flexibility so that each complex may apply the rule in a manner best suited to its organization."[33] The SEC's rationale for providing this flexible framework is based, in part, on the recognition that there are fundamental differences among funds, and a "one-size-fits-all" approach is a poor substitute for a tailored compliance program that requires approval by, and reporting to, the fund's "independent watchdogs" – that is, its board. We believe that the purposes of Rule 38a-1 are analogous to the policy objectives of the Proposed Rule, such that a similar principles-based approach should be adopted in place of the approach required by the Proposed Rule.

Finally, the flexibility of a principles-based approach to fair value determination oversight would be much more cost-efficient and would allow each fund board to take into consideration the distinct risks posed by the fair value process for its funds in structuring an oversight framework. In our

32 This would apply to the investment adviser or other Permissible Assignee, to the extent the scope expansion we propose above is implemented.

33 *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299, 68 Fed. Reg. 74714, 74717 (Dec. 24, 2003) (internal citations omitted).

experience, boards have been successful in implementing fair value processes that result in reliable fair values.

To the extent that the SEC is unwilling to consider the board reporting approach proposed here, we nonetheless request that the SEC reconsider certain aspects of the Periodic and Prompt Reporting Conditions. Specifically, in lieu of the Periodic and Prompt Reporting Conditions, we recommend an adviser be required to provide to the board (i) a written annual report that addresses the operation of the adviser's valuation procedures and processes and assesses their adequacy and effectiveness of implementation (similar to the approach under the Liquidity Risk Management Rule) and (ii) a written quarterly report that addresses material changes to the adviser's valuation procedures and processes and any material matters involving valuation identified during the quarter.[34] Similar to the "definition of material compliance matter" under Rule 38a-1, a material matter involving valuation would refer to any matter about which the fund's board would reasonably need to know to oversee fund valuation.[35] Of course, boards could – and likely would – request additional information from the adviser on a periodic basis. We believe that this approach would set forth certain minimum standards, but otherwise allow boards the flexibility to work with advisers to develop a reporting system that is appropriate based on a fund's facts and circumstances.[36]

D. The Commission Should Clarify the Reasonable Segregation Condition for Purposes of any Final Rulemaking

We recommend that, as part of any final rulemaking, the SEC clarify in the rule text that, consistent with statements made in the Proposing Release, the Reasonable Segregation Condition (defined below) does not prohibit the involvement of portfolio management and other investment

---

[34] We believe that any requirement to report on "[t]he adequacy of resources allocated to the process for determining the fair value of assigned investments" should be eliminated, as the adequacy of resources devoted to a particular function is difficult and unnecessary for a board to assess, and resource adequacy generally is more appropriately addressed as part of the contract review process under Section 15(c) of the 1940 Act.

[35] *See* Rule 38a-1(e)(2).

[36] This approach we propose is also consistent with that set forth in the Proposed Derivatives Risk Management Rule, which would require a derivatives risk manager to provide to the board (i) a written report on or before implementation of the derivatives risk management program and thereafter at least annually providing a representation that the program is "reasonably designed to manage the fund's derivatives risks" and to incorporate the required program elements and (ii) a written report, at a frequency determined by the board, regarding the derivatives risk manager's analysis of any exceedances of risk guidelines, and the results of certain stress testing and backtesting required under the program, that occurred since the last report to the board. *See* Proposed Rule 18f-4(c)(5)(ii)-(iii).

professionals (*e.g.*, traders) in the process of making fair value determinations. We believe that this clarification would be consistent with the purpose of the Reasonable Segregation Condition as described in the Proposing Release and would help to avoid confusion concerning its intended scope.

Under the Proposed Rule, one condition to a fund board assigning fair value determination responsibilities to an investment adviser of the fund would be that the "adviser . . . reasonably segregates the *process* of making fair value determinations from the portfolio management of the fund" (the "Reasonable Segregation Condition").[37] Phrased in this manner, we are concerned that there may be misinterpretation of the intended scope of this condition, as it could be read to prohibit any involvement of fund portfolio management in the process of making fair value determinations.

Notwithstanding the foregoing, the SEC acknowledged in the Proposing Release that a "fund's portfolio manager may be the most knowledgeable person at an investment adviser regarding a fund's portfolio holdings" and that "it may be appropriate for portfolio managers to provide input into the *process* for determining the fair value of fund investments."[38] The SEC noted further that the Reasonable Segregation Condition "is not meant to indicate that portfolio management must necessarily be subject to a communications 'firewall'" and indicated that the fair value determination process should be able to benefit from portfolio management's "important perspective and insight regarding the value of fund holdings."[39] While acknowledging potential conflicts of interest that portfolio managers may have in the fair valuation context, the SEC stated that the Reasonable Segregation Condition "would not prevent portfolio managers from providing inputs that are used in the fair value determination *process*."[40]

The SEC's concerns regarding portfolio managers' potential conflicts of interest in fair valuation echo concerns that the SEC has expressed in other recent rulemaking efforts.[41] In those cases, the

37 Proposed Rule 2a-5(b)(2) (emphasis added).

38 Proposing Release at 28747 (emphasis added).

39 Proposing Release at 28747-48.

40 Proposing Release at 28748 (emphasis added).

41 *Compare* Proposing Release at 28747 ("[W]e believe that a fund generally should consider the extent of influence portfolio managers may have on administration of the fair value process, and seek to provide independent voices and administration of the process as a check on any potential conflicts of interest to the extent appropriate.") *with* Liquidity Rule Adopting Release at 82213 ("We believe that a fund generally should consider the extent of influence portfolio managers may have on administration of the program, and seek to provide independent voices and administration of the program as a check on any potential conflicts of interest to the extent appropriate."). Similarly, compare the discussion in the Proposing Release at 28747-48:

SEC has not sought to completely remove portfolio management from the processes contemplated under those rules. Rather, the SEC sought to avoid portfolio management having exclusive jurisdiction over the outcome of the risk management processes that were the subjects of those rulemaking efforts.[42]

In light of the SEC's statements in the Proposing Release, as well as the similarities between the SEC's discussion in the Proposing Release and its discussion of analogous concepts in prior

---

> Separation of functions facilitates these important checks and balances, and funds could institute this proposed requirement through a variety of methods, such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel….In this regard, the reasonable segregation requirement is not meant to indicate that portfolio management must necessarily be subject to a communications "firewall." We recognize the important perspective and insight regarding the value of fund holdings that portfolio management personnel can provide.

with the discussion in the Derivatives Rule Proposing Release at 4458-59:

> Separation of functions creates important checks and balances, and funds could institute this proposed requirement through a variety of methods, such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel…In this regard, the reasonable segregation requirement is not meant to indicate that the derivatives risk manager and portfolio management must be subject to a communications "firewall." We recognize the important perspective and insight regarding the fund's use of derivatives that the portfolio manager can provide . . . .

42 *See* Rule 22e-4(a)(13) (defining "person(s) designated to administer the program" as "the fund or In-Kind ETF's investment adviser, officer, or officers (*which may not be solely portfolio managers* of the fund or In-Kind ETF) responsible for administering the program and its policies and procedures") (emphasis added); Liquidity Rule Adopting Release at 82213 ("Portfolio managers may also be *a part of* any committee or group designated to administer the program, if more than one person is so designated. . . . [W]e continue to believe that requiring the officer or officers responsible for administering the fund's liquidity risk management program *not to be solely portfolio managers* strikes the appropriate balance between independence and expertise.") (emphasis added); proposed Rule 18f-4(a) (defining "derivatives risk manager" in relevant part as "an officer or officers of the fund's investment adviser responsible for administering the program and policies and procedures . . . provided that the derivatives risk manager: (1) may not be a portfolio manager of the fund, or if multiple officers serve as derivatives risk manager, *may not have a majority composed of portfolio managers of the fund*") (emphasis added); proposed Rule 18f-4(c)(1) (requiring a fund's written derivatives risk management program to include policies and procedures "reasonably designed . . . to reasonably segregate the *functions associated with* the program from the portfolio management of the fund.") (emphasis added).

rulemaking efforts, we believe it would be consistent with the rationale for the Reasonable Segregation Condition to clarify in the rule text that the condition does not prohibit the involvement of portfolio management and other investment personnel in the *process* of making fair value determinations. This could be achieved, for example, by restating paragraph (b)(2) of the Proposed Rule to say, "[t]he adviser specifies the titles of the persons responsible for determining the fair value of the assigned investments, including by specifying the particular functions for which they are responsible, *which persons may not be solely portfolio managers of the fund*,"[43] or to say, "[t]he adviser specifies the titles of the persons responsible for determining the fair value of the assigned investments, including by specifying the particular functions for which they are responsible, and reasonably segregates *ultimate decision making authority with respect to* fair value determinations from the portfolio management of the fund."

IV. DEFINITION OF "READILY AVAILABLE MARKET QUOTATIONS"; RAMIFICATIONS FOR OTHER REGULATORY REQUIREMENTS

The Proposed Rule would provide that, for purposes of Section 2(a)(41) of the 1940 Act, 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.[44] This language in the Proposed Rule mirrors language defining "Level 1" inputs in the three-level fair value hierarchy of Financial Accounting Standards Board Accounting Standards Codification Topic 820 ("ASC Topic 820"). In effect, the Proposed Rule's characterization of readily available market quotations would define the scope of Rule 2a-5's application, as any investment valued using inputs classified as "Level 2" or "Level 3" inputs under ASC Topic 820 would necessarily be those for which market quotations are not readily available – *i.e.*, they must be fair valued.[45] As a practical matter, this means that

---

43 *Compare* Rule 22e-4(a)(13) with Proposed Rule 2a-5(b)(2).

44 Proposed Rule 2a-5(c). Under Section 2(a)(41)'s definition of "value," when market quotations are *not* readily available, value is defined as fair value as determined in good faith by the board.

45 *See also* Proposed Rule 2a-5(e)(2) (defining "fair value" as the value of a portfolio investment for which market quotations are not readily available under Proposed Rule 2a-5(c)); Proposing Release at 28755 ("To understand the extent of current boards' involvement in the valuation of funds' investments and the extent to which the proposed rule would affect funds' operations, we examine funds' investments under the U.S. GAAP fair value hierarchy. For purposes of this economic analysis, we treat investments that are valued using Level 1 inputs as investments for which readily available market quotations would be available, and investments valued using Level 2 and 3 inputs as investments that would be fair valued in good faith by the fund's board of directors.").

Under ASC 820, "Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date," and Level 2 inputs are "inputs *other than* quoted prices included within Level 1 that are observable for the asset or most debt securities will be classified as securities for which market quotations are not readily available. In the Proposing Release, the Commission acknowledged the importance of consistency between the valuation process and the current accounting guidance in ASC 820,[46] but chose to depart from this consistency by creating an overly narrow definition of "market price" and an overly broad definition of "fair valuation," rather than a system that is more consistent with the three levels of valuations based on the distinctions between observable and unobservable inputs. As discussed in Section II, we believe that a final rule should allow funds to adopt fair valuation methodologies that distinguish between different types of fair valuations based, for example, on the sources used for such valuations – similar to the three-tiered approach used in the accounting guidance.

In addition, it is important that the Commission clarify the impact of the Proposed Rule's characterization of readily available market quotations for other provisions of the 1940 Act and rules thereunder, including specifically Rule 17a-7 under the 1940 Act. The Proposed Rule states that its characterization of readily available market quotations is for purposes of Section 2(a)(41). Both the Proposed Rule and the Proposing Release are silent regarding implications of this characterization for other sections of, or rules under, the 1940 Act. Only oblique references to "all other purposes" and "all other circumstances" are included.[47]

Rule 17a-7, which exempts certain transactions from the affiliated transaction prohibitions of Section 17(a) of the 1940 Act, applies only with respect to securities "for which market quotations

---

liability, either directly or indirectly" and include "[q]uoted prices for identical or similar assets or liabilities in markets that are not active." *See* ASC 820-10-35-40; ASC 820-10-35-47 (emphasis added); ASC 820-10-35-48(b). Level 3 inputs are "unobservable inputs for the asset or liability." ASC 820-10-35-52.

For purposes of this discussion, we use "Level 1 securities" to refer to securities valued using inputs classified as Level 1 inputs under ASC Topic 820. Similarly, we use "Level 2 securities" to refer to securities valued using inputs classified as Level 2 inputs under ASC Topic 820.

46 *See, e.g.*, Proposing Release at 28739 ("To be appropriate under the rule, and in accordance with current accounting standards, a methodology used for purposes of determining fair value must be consistent with ASC Topic 820…").

47 In a footnote, it is noted that Section 2(a)(41)(A) defines value for certain purposes under Sections 3, 5 and 12 of the 1940 Act, that Section 28(b) of the 1940 Act contains certain valuation provisions for face-amount certificate companies, and that "Section 2(a)(41)(B) defines value for all other purposes under the Investment Company Act." Proposing Release at 28735 n.11. In addition, after stating the proposed characterization of readily available market quotations, it is noted in the Proposing Release, without further elaboration, that "[f]air value, as defined in the Act, therefore must be used in all other circumstances." Proposing Release at 28748.

are readily available."[48] While this suggests that Rule 2a-5's characterization of readily available market quotations would be applicable for purposes of Rule 17a-7, Rule 17a-7 has historically not been interpreted as unavailable for debt securities, as it would in effect be under the Proposed Rule's definition. For example, recent SEC enforcement actions relating to fund cross trades of fixed income securities focused not on any alleged lack of readily available market quotations, but instead on failures to comply with the technical pricing provisions of Rule 17a-7.[49] If the SEC were of the view that fixed income securities were, *per se*, ineligible for cross trades under Rule 17a-7 due to market quotations being *per se* not readily available, it did not indicate this in these recent enforcement actions and instead focused significant attention on other elements of Rule 17a-7. In fact, in the Western Asset case, the SEC specifically discussed how Rule 17a-7 is typically applied in the context of debt securities:

> Rule 17a-7 under the [1940] Act exempts from the prohibitions of Section 17(a) certain purchases and sales between [registered investment companies] and certain affiliated persons, where the affiliation arises solely because the two have a common investment adviser, common directors, and/or common officers, provided that the transactions are effected in accordance with the requirements set forth in Rule 17a-7. Among those is the requirement that the adviser execute the cross trade in accordance with the Rule's method for determining the "current market price," which, ***<u>for most bonds</u>***, is defined as "the average of the highest current independent bid and lowest current independent offer, determined on the basis of reasonable inquiry."[50]

Thus, as we understand that funds treat many debt securities as Level 2 securities, and as Rule 17a-7 has not been interpreted to exclude debt securities *per se*, it is important that the Commission expressly state that the Proposed Rule's characterization of readily available market quotations is

48 Rule 17a-7(a).

49 *See, e.g.*, In the Matter of Putnam Investment Management, LLC, *et. al*, Investment Company Act Rel. No. 33257 (Sept. 27, 2018) ("By cross trading [certain non-agency residential mortgage-backed securities] at the bid, *rather than at an average between the highest current independent bid and the lowest current independent offer* [as required under Rule 17a-7(b)(4)], Harrison caused Putnam to favor the buyers in the transactions over the sellers, even though both were advisory clients to which Putnam and Harrison owed the same fiduciary duty.") (emphasis added); In the Matter of Western Asset Management Co., Investment Company Act Rel. No. 30893 (Jan. 7, 2014) ("Western Asset") ("By cross trading [certain fixed income] securities at the bid, rather than at an average between the bid and the ask, Western favored the buyers in the transactions over the sellers, even though both were advisory clients of Western and owed the same fiduciary duty.").

50 Western Asset at 3 - 4 (emphasis added).

not intended to change the SEC's and the staff's guidance regarding Rule 17a-7. Instead, any changes to the scope of Rule 17a-7 should be made through a separate rulemaking.

V. ADDITIONAL COMMENTS

A. The Allocation of Expenses Associated with the Proposed Rule is a Question of Contract Law

The Proposing Release indicates that, where a board does not assign fair value responsibilities to an adviser, the fund will bear the initial and ongoing costs associated with the Proposed Rule, while the adviser would bear such costs in the event of an assignment.[51] While we agree that compliance with the Proposed Rule, as proposed, would result in significant expenditures, we do not believe it is appropriate to presume which party would bear the relevant costs in either scenario. Instead, it is our view that the allocation of such expenses would be governed by existing contractual arrangements between funds and their investment advisers, which is a matter of state contract law, fund documents and agreement between a fund board and service providers, as applicable. Accordingly, we recommend that the SEC, as part of any final rulemaking, not make definitive statements about the parties that would bear expenses associated with the Proposed Rule.

B. The Compliance Period Should be Extended to 18 Months

The Proposing Release indicates that there would be a one-year transition period for funds and their advisers to come into compliance with any final rulemaking. We believe that, in order to grant funds sufficient time to adjust to and implement the new requirements, the Commission should extend the compliance period from one year to 18 months. Funds, fund boards, and investment advisers will need time to develop and implement valuation and reporting processes that comply with the final rulemaking and are tailored to the unique features, characteristics, and preferences of the specific funds and fund boards. We expect this will take time and resources, particularly given the number of parties involved (such as boards, investment advisers, pricing vendors, and other fund service providers). In addition, given the SEC's current rulemaking agenda in general and expectations for the issuance of final rulemaking in a number of key areas before the end of 2020, it is possible funds will at the same time be implementing other regulatory changes. Accordingly, we believe that an 18-month transition period is more appropriate in light of the updates that will need to be made under a final Rule 2a-5.

---

[51] Proposing Release at 28759-60.

*   *   *   *   *

We appreciate the opportunity to comment on the Proposing Release. Please feel free to contact Stephanie A. Capistron at (617) 728-7127, Stephen H. Bier at (212) 698-3889, Julien Bourgeois at (202) 261-3451, Mark D. Perlow at (415) 262-4530, Jeremy I. Senderowicz at (212) 641-5669, Nicholas DiLorenzo at (617) 728-7171 or Aaron D. Withrow at (202) 261-3442 with any questions about this submission.

Very truly yours,

/s/ Dechert LLP

Dechert LLP