

## COMMENT LETTER

July 16, 2020

# ICI Comment Letter on SEC's Fair Value Proposal (pdf)

July 16, 2020 Ms. Vanessa A. Countryman Secretary Securities and Exchange Commission  
100 F Street, NE Washington, D.C. 20549 Re: Good Faith Determinations of Fair Value, File Number S7-07-20 Dear Ms. Countryman: The Investment Company Institute<sup>1</sup> applauds the SEC for taking steps to improve and modernize the regulatory framework for fund valuation of portfolio securities.<sup>2</sup> The proposal appropriately reflects the roles of fund boards and investment advisers, and correctly recognizes the importance of accounting standards to funds' fair value determination process. We recommend several refinements to the proposal that would position the SEC to adopt a final rule that benefits shareholders, funds, boards, and investment advisers. 1 The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US\$24.8 trillion in the United States, serving more than 100 million US shareholders, and US\$6.5 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC. 2 Good Faith Determinations of Fair Value, SEC Release No. IC-33845 (Apr. 21, 2020) ("Proposing Release"), available at: [www.sec.gov/rules/proposed/2020/ic-33845.pdf](http://www.sec.gov/rules/proposed/2020/ic-33845.pdf). Ms. Vanessa A. Countryman July 16, 2020 Page 2 I. Background and Executive Summary The Investment Company Act requires open-end funds to value each of their portfolio holdings every business day, a hallmark of the Act since its enactment in 1940.<sup>3</sup> The Act establishes a two-pronged approach to valuation: securities for which market quotations are readily available must be priced at market value, and all other securities must be assigned a fair value as determined in good faith by the fund's board, i.e., the price that a fund might reasonably expect to receive upon its current sale. Section 1(b), which articulates the policy and purposes behind the Act, underscores valuation's importance: "it is hereby declared that the national public interest and the interest of investors are adversely affected...when investment companies, in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny... ." Funds take these requirements seriously, and the design, implementation, and oversight of valuation policies and procedures are key compliance obligations. Since 1940, the Commission and its staff have issued guidance periodically to assist funds in carrying out these responsibilities. This proposal will facilitate fund compliance by replacing decades of guidance appearing in Commission releases, staff letters, and accounting series releases with: □ a rule focused on the fair value process,

allocation of fair value-related responsibilities, reporting to the board, and board oversight; and the valuation framework established by the Financial Accounting Standards Board (FASB), the Commission-designated accounting standard setter. We strongly support providing fund boards the ability to assign fair value responsibilities to investment advisers. The proposal recognizes that a fund board's role is typically one of oversight, with the investment adviser (and other entities, including pricing services) establishing methodologies and doing the day-to-day valuation work. We further explain our support for these aspects of the proposal in Section II. We recommend that the Commission adopt a final rule that accounts for practical aspects of the daily valuation process. Substantially all fixed income securities would be subject to the proposed requirements because the proposal does not regard them as having readily available market quotations. As of year-end 2019, approximately \$4.7 trillion in mutual fund assets, \$814 billion in ETF assets, and 3 The Act requires closed-end funds and BDCs (together with open-end funds, "funds") to periodically value each of their portfolio holdings, with most closed-end funds choosing to do so every business day. Ms. Vanessa A. Countryman July 16, 2020 Page 3 \$171 billion in closed-end fund assets were in bond funds,<sup>4</sup> and US registered funds collectively held \$8.3 trillion in fixed income securities.<sup>5</sup> Some fund complexes must determine fair value for thousands—or tens of thousands—of fixed income securities each business day, all within a couple of hours of the fund's closing time (typically 4:00 pm).<sup>6</sup> In sum, funds' fair value work is voluminous, complex, frequent, and temporally demanding. To better account for these practical realities, we recommend that the rule's requirements: (i) be more reasonably tailored to reflect differences in fair value practices, risks, and challenges across asset types (e.g., valuation-related practices and risks for investment grade bonds and private equity investments differ significantly); and (ii) more accurately capture the typical allocation of responsibilities between investment advisers and pricing services. Pricing services are equipped to handle efficiently certain tasks on a timely basis, and funds consider their services essential. Funds and advisers hire and oversee pricing services as they do other key third-party service providers—onboarding them only after rigorous initial due diligence and then continuing to evaluate and oversee them in accordance with well-developed practices and compliance policies and procedures adopted consistent with Rule 38a-1 under the Investment Company Act (the "compliance rule"). Allowing fund boards, investment advisers, and pricing services to fulfill their distinct and complementary responsibilities in accordance with their relative strengths is far more likely to lead to sound fair value determinations—the critical policy objective—than would permitting only fund boards or advisers to perform certain tasks. We therefore recommend that any final rule permit both pricing services and fund advisers to establish and apply fair value methodologies. We further recommend that the Commission scale back certain of the recordkeeping requirements to better reflect the nature of fixed income security valuation. We also recommend modifying the frequency, timing, and content of information the adviser must report to the fund's board. The SEC should require annual (instead of quarterly) reporting for most items and limit quarterly reporting to especially timely and significant items. These changes would better facilitate focused and effective board oversight. 4 2020 Investment Company Fact Book, at 198, 204, 206, available at [www.ici.org/pdf/2020\\_factbook.pdf](http://www.ici.org/pdf/2020_factbook.pdf). ICI classifies funds as "bond funds" based on their investment objectives and principal investment strategies as disclosed in their prospectuses, and such funds may invest in securities other than debt. See also Proposing Release at 84-85 (estimating that nearly 10,000 funds could be affected by the proposal, and that approximately 33 percent of fund assets could be affected). 5 This figure includes corporate and foreign bonds, Treasury and agency securities, municipal bonds, and commercial paper held in mutual funds, money market funds, ETFs, closed-end funds, and unit investment trusts (UITs). 6 Mutual funds strive to release their net asset value (NAV)

per share by 6:00 pm Eastern time so that intermediaries and other fund share trade processors can initiate their nightly processing cycle. During periods of market volatility, however, the release of the NAV may be delayed for several hours or more. Ms. Vanessa A. Countryman July 16, 2020 Page 4 We further recommend recasting the final rule as a non-exclusive means of establishing compliance with the statutory requirement to “determine fair value in good faith” (i.e., a safe harbor). This approach would recognize that this statutory requirement neither compels funds to determine fair value in a single way, nor readily translates into an exclusive set of rule requirements. The diverse and evolving set of practices that funds have employed in determining fair value is fully consistent with this “good faith” standard, and these determinations are widely recognized to be more art than science. As the Commission has stated, “no single standard for determining ‘fair value in good faith’ may be laid down since fair value depends upon the circumstances of each particular case.”<sup>7</sup> We expand on these comments and recommendations in Section III. We conclude by commenting on more discrete matters in Section IV. We support:

- Permitting sub-advisers to assume fair value responsibilities;
- Leaving the type and frequency of fair value methodology testing to the fund’s discretion;<sup>8</sup> and
- Applying audit standards that permit sampling and other techniques to verify the values of portfolio securities.

We recommend that the SEC:

- Permit a fund board to assign fair value responsibilities to entities other than investment advisers, such as fund administrators;
- Reaffirm that deviations in methodologies, inputs, and resulting fair value determinations are inevitable across—and even within—fund complexes;
- Focus on the process, rather than specific criteria, of price challenges;
- Permit not only trustees, but also depositors and other entities to carry out fair value responsibilities for UITs;
- Affirm funds’ current ability to cross-trade certain securities; and
- Provide an 18-month compliance period.

<sup>7</sup> Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118 (Dec. 23, 1970) (ASR 118). <sup>8</sup> We also recommend clarifying that parties other than the adviser may test fair value methodologies. Ms. Vanessa A. Countryman July 16, 2020 Page 5 II. ICI Supports the SEC’s Overall Rulemaking Approach We support the proposal’s overall approach. Specifically, it would:

- Establish specific valuation practices<sup>9</sup> for all funds to apply to portfolio investments that do not have readily available market quotations;
- Impose additional oversight and reporting obligations where a fund’s board assigns fair value responsibilities to an investment adviser; and
- Rescind prior SEC and staff guidance on valuation and defer to existing accounting standards.

The proposal rightly avoids providing comprehensive guidance about how funds should determine fair value for their wide array of portfolio investments. We appreciate that the Commission has not prescribed detailed methodological or investment-specific valuation guidance and instead emphasizes process, reporting to the board, and board oversight. The complexity of valuation and the varied and evolving industry practices strongly buttress this policy choice. We recommend discrete changes to some of the proposal’s specific process- and reporting-oriented requirements in Sections III and IV. A. ICI Supports the SEC’s Proposed Rescission of Prior SEC and Staff Valuation Guidance We support the SEC rescinding prior SEC and staff guidance on valuation and instead deferring to existing accounting standards.<sup>10</sup> As the Proposing Release notes, the SEC last comprehensively addressed fund valuation in 1969 and 1970 releases, Accounting Series Release 113<sup>11</sup> and ASR 118. These ASRs are not inconsistent with current accounting standards, but we do not regard them as essential or otherwise additive. We further believe that funds’ valuing assets solely in accordance with existing accounting standards would sufficiently protect shareholders. Funds and their auditors currently look to ASC Topic 820 to determine the fair value of investment securities, both for daily valuation and financial reporting purposes. The FASB’s accounting standards represent a more modern and comprehensive approach to valuation and accounting issues than do the ASRs. Specifically, ASC Topic 820 defines the term “fair <sup>9</sup> The

proposal's general requirements under paragraph (a) would include: (i) periodically assessing and managing material risks associated with fair value determinations, including material conflicts of interest; (ii) establishing and applying fair value methodologies; (iii) testing fair value methodologies; (iv) overseeing and evaluating any pricing services used; (v) adopting and implementing written fair value policies and procedures; and (vi) satisfying recordkeeping requirements. 10 FASB Accounting Standard Codification Topic 820: Fair Value Measurement (ASC Topic 820). 11 Statement Regarding "Restricted Securities," Accounting Series Release No. 113 (Oct. 21, 1969) (ASR 113, and together with ASR 118, the ASRs). Ms. Vanessa A. Countryman July 16, 2020 Page 6 value"12 and provides a comprehensive framework for measuring and disclosing the wide array of fund investments. And ASC Topic 946, Financial Services – Investment Companies, addresses recognition, measurement, and disclosure of investment company investments. Indeed, the SEC recognized the FASB's financial accounting and reporting standards as "generally accepted" for purposes of the federal securities laws and indicated that registrants are required to comply with them when preparing financial statements filed with the SEC.13 For these reasons, we support the rescission of the ASRs and all other prior SEC and staff guidance on valuation, which we believe would provide greater clarity in this space.14 Moreover, the fund industry currently looks primarily to accounting standards to fair value all portfolio investments every day. Any new guidance from the SEC risks: (i) creating confusion and potential conflicts, if the two are not perfectly aligned; and (ii) becoming out-of-sync with accounting standards, as valuation practices and the investment landscape evolve.

**B. ICI Strongly Supports the SEC's Proposed Framing of the Fund Board's Role** We strongly support framing the fund board's role as one of oversight. Tension has long existed between the Investment Company Act's requirement that fund boards determine "fair value" for securities without readily available market quotations on the one hand, and the practicalities of fund 12 ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC Topic 820 emphasizes that fair value represents an "exit price" (i.e., the price received to sell under current market conditions). We believe the concept of "fair value" described in ASC Topic 820 is substantially identical to that described in the ASRs. 13 The SEC first recognized the pronouncements of the FASB as authoritative in 1973, shortly after issuance of ASR 113 and ASR 118. See ASR 150 (December 20, 1973). In 2002, the SEC determined that the FASB's standards are generally accepted for purposes of the federal securities laws. See Policy Statement: Reaffirming the Status of the FASB as a Designated Private Sector Standard Setter, SEC Release No. IC-26028 (Apr. 25, 2003). 14 One commenter has suggested that retaining ASR 118 and its recitation of factors to be considered in determining the fair value of a security (i.e., size of holding) is necessary to address block discounts and valuation of fixed income odd lots. We disagree. These issues—termed "unit of account" in the accounting standards codification—are addressed by ASC Topic 820. Unit of account is the level at which an asset or liability is aggregated or disaggregated for purposes of recognition within the financial statements. For actively traded securities fair value is the last traded price, regardless of the size or quantity of shares traded. ASC Topic 820 precludes application of any discount to the price, even where average daily trading volume is not sufficient to absorb the quantity held and placing an order to sell the entire position in a single transaction may affect the price. Specifically, ASC Topic 820-10-35-44 indicates that, within Level 1, fair value shall be measured as the product of the quoted price and the quantity held. With respect to fixed income odd lots, ASC Topic 820 indicates that fair value is a market-based measurement that represents the amount that would be received to sell an asset (i.e., an exit value). The fixed income odd lot would be recognized in the financial statements at the quantity held (i.e., less than a round lot) and would be measured at the odd lot exit price,

reflecting any discount to the round lot price that would be realized upon sale. Ms. Vanessa A. Countryman July 16, 2020 Page 7 valuation on the other. The complexity, volume, frequency, and tight time constraints of fair value tasks mean that they are challenging and resource-intensive for funds generally. The SEC and staff have recognized this tension in past guidance and made clear that boards alone need not fully shoulder these obligations. For instance, ASR 118 stated that “it is incumbent upon the Board of Directors to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and to determine the method of arriving at the fair value of each such security. To the extent considered necessary, the board may appoint persons to assist them in the determination of such value, and to make the actual calculations pursuant to the board's direction.” While statements such as this have helped, they still overstate what can reasonably be expected of fund boards with respect to design of fair value methodologies and scrutiny of their application, and they understate the valuable work and capabilities of investment advisers and other service providers. We therefore commend the SEC for clarifying that the board’s role (if it chooses) may be solely one of oversight, and the proper role of the adviser may extend well beyond merely “assisting” the board. At the same time, we fully agree that valuation remains a function that boards must oversee, given its importance to fund investors and the potential conflicts that may arise.<sup>15</sup> And we believe that periodic reporting to the board will provide for effective oversight.<sup>16</sup> The proposal correctly distinguishes between oversight on the one hand and design and administration on the other, and it is superior to prior SEC and staff guidance in this area.

### III. General Comments on the Proposal and Related Recommendations

We recommend immediately below changes to several of the proposal’s elements.

#### A. ICI Recommends that the SEC Tailor Requirements to Reflect Current Practices

The proposal’s requirements would apply to any portfolio investments that do not have readily available market quotations, and the requirements do not calibrate or otherwise distinguish how funds (or boards or advisers) must determine fair value for these investments. In doing so, the proposal takes a binary approach to funds’ portfolio investments: each investment either has a readily available market quotation (and thus is outside the rule), or it does not, in which case it is fully subject to the rule’s requirements. By contrast, the accounting standards more granularly delineate among three categories,

<sup>15</sup> See generally Board Oversight of Certain Service Providers, Independent Directors Council Task Force Report, June 2007, available at [www.idc.org/pdf/21229.pdf](http://www.idc.org/pdf/21229.pdf). <sup>16</sup> We recommend improving the proposed board reporting regime in Section III.B below, however.

Ms. Vanessa A. Countryman July 16, 2020 Page 8 taking into account the transparency of pricing inputs and the degree of market activity.<sup>17</sup> The accounting hierarchy thereby acknowledges that all portfolio investments do not pose the same valuation-related challenges and risks, and any final SEC rule should share this key premise. Also, the proposal does not accurately capture the nature of the relationship, and respective responsibilities, of investment advisers and pricing services. The proposed rule includes pricing services, but does not fully recognize their important role in establishing and applying fair value methodologies. This creates two problems. First, the proposal requires the investment adviser<sup>18</sup> to “[e]stablish and apply fair value methodologies.” This could be read as requiring the adviser—and only the adviser—to do so. In practice, however, advisers frequently rely on pricing services to perform these functions, subject to an initial due diligence and onboarding process and continued oversight.<sup>19</sup> Second, the recordkeeping provision requires funds to maintain “[a]ppropriate documentation to support fair value determinations, including information regarding the specific methodologies applied and the assumptions and inputs considered when making fair value determinations...” The Proposing Release describes the necessary documentation as that which “would be sufficient for a third party to verify the fair value determination.”<sup>20</sup> Some

investment advisers invest in thousands—or tens of thousands—of fixed income securities, and pricing services provide prices for them each business day. Advisers may not receive more than the evaluated price itself, and recordkeeping of any additional information is not common, given its volume and limited utility. As proposed, this recordkeeping requirement would add costs related to: (i) acquiring daily CUSIP-specific data that funds do not 17

These categories are as follows: Level 1 – quoted prices (unadjusted) in active markets for identical financial instruments that the fund can access at the measurement date; Level 2 – inputs other than Level 1 quoted prices that are observable, either directly or indirectly (including, but not limited to, quoted prices for similar financial instruments in active markets, quoted prices for identical or similar financial instruments in inactive markets, interest rates and yield curves, implied volatilities and credit spreads); and Level 3 – unobservable inputs. Observable inputs are developed using market data, such as publicly available information about actual events or transactions and reflect the assumptions that market participants would use to price the financial instrument. Unobservable inputs are those for which market data are not available and are developed using the best information available about the assumptions that market participants would use to price the financial instrument. 18 We recognize that the rule also would permit the fund board to carry out this function and others in paragraph (a), and in Section IV.A below we recommend adopting a definition of “assignee” to include other entities. For clarity, however, we generally refer to the adviser as performing these responsibilities on behalf of the fund throughout this letter. 19 The initial due diligence and onboarding process enables the adviser to ensure that the pricing service’s methodologies, inputs, and assumptions are consistent with fair value requirements. The adviser performs continuing oversight of the pricing service (e.g., through price challenges or more extensive evaluations of particular valuations) in an effort to ensure that the prices it receives represent fair value. 20

Proposing Release at 30. Ms. Vanessa A. Countryman July 16, 2020 Page 9 receive today, and otherwise would not choose to acquire; and (ii) maintaining this back-up information for the prescribed period. We recommend modest rule text changes to address both issues. Instead of requiring a fund to “establish and apply fair value methodologies,” the fund should be required to “establish how fair value determinations could be made for portfolio investments.” This formulation makes clear that funds: □ may rely on pricing services’ methodologies and their application thereof, while also permitting advisers to establish and apply their own methodologies for specified investments as necessary and appropriate (e.g., Level 3 investments); and □ need not pre-determine precisely which methodology would apply to each portfolio holding, as the fair value process is not that formulaic. 21 This recommended approach comports with funds’ deep experience with overseeing key service providers—including pricing services. 22 Under this approach, where a fund relies on the methodologies, assumptions, and inputs of a pricing service, the adviser would be obligated to have a reasonable understanding of those items as part of its evaluation responsibilities. Importantly, the proposed rule’s provision on overseeing pricing services and its related guidance adequately address this responsibility. 23 Further, we recommend bifurcating the recordkeeping requirement to require detailed recordkeeping to support fair value determinations only for those investments for which the fund (including the fund board or any assignee) establishes and applies its own methodologies (e.g., for Level 3 investments). Our recommended approach would reduce significantly the costs and burdens that the proposed recordkeeping requirements would impose, especially for those fund complexes that invest in large numbers of fixed income securities. Our approach also more closely resembles that of Rule 22e-4 (the “liquidity rule”), which does not require funds to maintain information supporting the monthly classification determinations for each investment. 24 21 See Section IV.B below for examples of situations where different methodologies may be applied to assets within the same asset class. 22 See Compliance Programs of Investment

Companies and Investment Advisers, SEC Release No. IA-2204 (Dec. 17, 2003)(“Compliance Program Rule Adopting Release”), at n.28 (noting that limiting the service providers named in rule 38a-1 did not lessen a fund’s obligation to consider compliance as part of its decision to employ other entities, such as pricing services). 23 We believe the proposed rule’s approach is consistent with funds’ obligation to know that the fair value measurements included in their financial statements and the related methodologies are consistent with generally accepted accounting principles. 24 See Investment Company Act Rule 22e-4(b)(3). Ms. Vanessa A. Countryman July 16, 2020 Page 10 We propose specific amendments to effectuate these recommendations in Appendix A.25 B. ICI Recommends that the SEC Modify the Board Reporting Requirements to Better Facilitate Sound Oversight Where a fund board has assigned fair value responsibilities to an investment adviser, the proposal would require continued board oversight of the adviser and a detailed regime consisting of periodic (i.e., at least quarterly)26 and “prompt”27 reporting to the board. As proposed, the frequency, timing, and content of the reporting items will not in practice result in effective board oversight. With respect to the quarterly reporting requirements, some will experience little or no change each quarter (e.g., assessment, and management, of material valuation risks). Including such items each quarter risks making this a rote reporting exercise and over time would undermine the effectiveness of the reporting regime. We have several concerns with the “prompt” reporting requirement. First, its scope is overly broad and vague. Ascertaining what “could have materially affected” fair value is highly speculative and not prone to prompt or certain conclusions. Nor do we agree that “material changes in the fund’s valuation risks” ought to trigger prompt board reporting,28 especially if the SEC believes a “significant increase in price 25 See Appendix A for a marked version of this and other recommended changes to proposed Rule 2a-5. Alternatively, to address these specific points, the SEC could incorporate into the final rule the concepts of Level 2 and 3 securities (much as it has modeled its definition of “readily available market quotation” on that of a Level 1 security), and specify different obligations for each. We prefer what we have outlined herein because we believe it will be a more durable way to address our concerns. In addition to our recommended rule text changes, the SEC could address in guidance its expectations with respect to key inputs and assumptions for those investments for which the adviser establishes and applies the methodology. See also Section IV.B below, which explains our concerns with the proposal’s requirements with respect to “consistent” application of fair value methodologies. 26 Specifically, this periodic board reporting would require quarterly assessments of the adequacy and effectiveness of the adviser’s fair value process, including a summary or description of: (i) assessment and management of material valuation risk; (ii) any material changes to, or material deviations from, established fair value methodologies; (iii) testing results; (iv) adequacy of resources allocated to the fair value process, including any material changes to the roles or functions of the responsible persons; (v) any material changes to the adviser’s process for selecting and overseeing pricing services, as well as material events related to this oversight (such as changes in service providers or price overrides); and (vi) any other materials requested by the board. 27 This would require prompt (i.e., in no event later than three business days after the adviser becomes aware of the matter) reporting on matters associated with the adviser’s process that materially affect or could have materially affected the fair value of the investments, including a significant deficiency or material weakness in the design or implementation of the adviser’s fair value process or material changes in the fund’s valuation risk. 28 The proposal already would require quarterly reporting on material valuation risks, lessening the need to incorporate it into any prompt reporting requirement. Ms. Vanessa A. Countryman July 16, 2020 Page 11 challenges or overrides” would indicate such a change.29 Particularly in stressed market conditions such as those experienced in March 2020 (where price

challenges increased significantly), such a proposed requirement could generate significant “noise” for a fund board. Had this provision been in effect in March, some fund boards may have received “prompt” reports on a daily basis, without reflecting any significant fair value issues or concerns.<sup>30</sup> An obligation this broad and undefined would be difficult to administer and create reporting that in many cases would not be deserving of a board’s prompt attention.<sup>31</sup> Second, the item’s three-day window for reporting—which tolls beginning when the adviser becomes “aware of the matter”—is insufficient to investigate, confirm materiality, and prepare a report to the board. This is especially so for assessments of matters that “could have materially affected” fair value, or “material changes in the fund’s valuation risks.” Instead, we recommend a reporting framework more closely resembling those in the compliance and liquidity rules.<sup>32</sup> To that end, and as set forth in Appendix A, we recommend: □ Deleting the adequacy of resources assessment as a required item and permitting boards and advisers to determine how best to address this matter;<sup>33</sup> □ Making most of the periodic items annual reporting items; 29 See Proposing Release at n.113: “For example, a significant increase in price challenges or overrides likely would reflect a material change to the fund’s valuation risks that should be promptly reported to the board.” 30 See Section IV.D below for a discussion of price challenges. 31 Cf. Rule 22e-4, whose only similarly-demanding board reporting requirement is triggered when an open-end fund’s percentage of illiquid investments exceeds 15 percent, an infrequent and meaningful occurrence. 32 See Investment Company Act Rule 38a-1(a)(4)(iii) (requiring the fund’s chief compliance officer to provide an annual written report to the board that addresses: (i) the operation of the policies and procedures of the fund and each investment adviser, principal underwriter, administrator, and transfer agent of the fund, any material changes made to those policies and procedures since the date of the last report, and any material changes to the policies and procedures recommended as a result of the annual review of the fund’s and specified service providers’ policies and procedures; and (ii) each material compliance matter that occurred since the date of the last report) and Rule 22e-4(b)(2)(iii) (requiring the fund’s liquidity program administrator to provide an annual report to the board that addresses the operation of the program and assesses its adequacy and effectiveness of implementation). 33 This is an important consideration for boards, but we do not believe quarterly reporting is necessarily the best or only means of addressing it (this assessment would likely change little from quarter-to-quarter). Even if the SEC eliminates this required reporting item, a fund board still could mandate reporting of this type (see Rule 2a-5(b)(1)(i)(F)). Alternatively, a fund board may wish to review this information in the annual contract review process (as part of the board’s assessment of the nature and quality of the services that the adviser provides to the funds), or periodically meet with the fund’s Principal Financial Officer or independent accountant to discuss this subject. Providing the board with the flexibility to institute a tailored process is superior to the SEC mandating a single approach. Ms. Vanessa A. Countryman July 16, 2020 Page 12 □ Requiring, as quarterly reporting items (if they occur), descriptions of: o Material changes to valuation risks or adviser-applied fair value methodologies (or material deviations therefrom); and o Significant deficiencies or material weaknesses in the design or implementation of the adviser’s fair value determination process (this would replace the proposed “prompt” reporting requirements).<sup>34</sup> Generally speaking, we believe these board reporting requirements should be more flexible<sup>35</sup> because the proposal rightly requires the adviser to provide the fund board with “[a]ny other materials requested by the board... .” This provision would work well alongside a more reasonable set of baseline reporting requirements, providing boards and advisers the discretion to craft reporting protocols most germane to their funds’ specific needs. Boards are accustomed to collaborating with advisers and exercising their business judgment in this way. We also believe that excessive board reporting would run counter to the SEC staff’s recent work in permitting more



streamlined forms of board reporting, consistent with the board's oversight role.<sup>36</sup> Finally, the Proposing Release suggests that, in addition to the items included in the rule text, "a board could review and consider, if relevant" several other items.<sup>37</sup> We recommend removing from any adopting release these suggested reporting items, which fund complexes could feel compelled to treat as de facto requirements. At a minimum, any adopting release should affirm that fund complexes are under no obligation or expectation to include such items in their board reports. <sup>34</sup> Boards still could insist upon more frequent forms of reporting, as they deem necessary and appropriate. Cf. Compliance Program Rule Adopting Release, at nn. 33 and 84 (noting that, notwithstanding the compliance rule's requirement that "material compliance matters" be reported to the board at least annually, "[s]erious compliance issues must, of course, always be brought to the board's attention promptly ..."). If the SEC rejects this approach, at a minimum, it must address the specific concerns expressed above regarding the proposed rule text. A revised provision could state, "The Assignee reports on any significant deficiency or material weakness in the design or implementation of the fund's fair value determination process that materially affected the fair value of the assigned portfolio of investments, no later than three business days after investigation and confirmation by the Assignee." Further, the SEC could state in guidance that any investigation of such deficiencies or weaknesses must be completed as promptly as reasonably practicable. <sup>35</sup> See Commissioner Hester M. Peirce, Statement on Good Faith Determinations of Fair Value under the Investment Company Act of 1940 Proposal (Apr. 21, 2020) (questioning the level of prescription in the proposed board reporting requirements), available at [www.sec.gov/news/public-statement/statement-peirce-fair-value-2020-04-21](http://www.sec.gov/news/public-statement/statement-peirce-fair-value-2020-04-21). <sup>36</sup> Independent Directors Council, SEC Staff No-Action Letter (Oct. 12, 2018)(permitting a fund board to receive quarterly representations from the fund's chief compliance officer that transactions effected in reliance on certain exemptive rules complied with the board-adopted procedures, instead of requiring the board to determine compliance). <sup>37</sup> Proposing Release at 46-47 (emphasis added). These recommended items include, among others, price challenge summaries, calibration and back-testing data, and stale price reports. Ms. Vanessa A. Countryman July 16, 2020 Page 13 C. ICI Recommends that the SEC Recast the Rule as a Safe Harbor The Proposing Release does not indicate how, if at all, the SEC believes this rule would affect the potential liability of funds, boards, and advisers in fulfilling their fair value responsibilities. We are concerned that the SEC might view this rule as an additional tool to bring enforcement actions based on findings of technical non-compliance with its enumerated requirements. As noted above, we support the rule's overall approach and do not object on policy grounds to several of its elements. Still, a valuation rule with so many enumerated requirements and detailed expectations—compliance with which, paragraph (a) states, is required to determine fair value in good faith—is at odds with the statutory language, prior SEC and staff guidance, and funds' decades of experience operating in accordance with the standard while employing varying practices. While we support the rescission of prior SEC and staff guidance on valuation, it contains important insights into the meaning of this "good faith" standard that should guide the SEC in promulgating this rule. For instance, the SEC has stated that "[n]o single standard for determining 'fair value \*\*\* in good faith' can be laid down, since fair value depends upon the circumstances of each individual case."<sup>38</sup> Similarly, the staff has characterized "good faith" as "a flexible concept that can accommodate many different considerations...".<sup>39</sup> The statute's overriding requirement—determining fair value in good faith—does not translate into a single and exclusive "to do" list. Our members currently discharge their fair value obligations with care and skill, utilizing various processes and practices that have developed, and may continue to develop, over time. The Commission already has numerous means to bring enforcement actions against those who fail to satisfy

their valuation-related responsibilities.<sup>40</sup> The SEC therefore should recognize explicitly in any adopting release that funds may satisfy the statutory good faith standard by employing practices that may vary from the rule's requirements, but nevertheless demonstrate care and good faith. These considerations strongly support recasting this rule in less absolute terms and instead as a non-exclusive means of establishing statutory compliance, i.e. a safe harbor.<sup>41</sup> Under this approach, compliance with the rule would establish compliance with the statute's fair value requirement, but a 38 ASR 118. 39 Investment Company Institute, SEC Staff No-Action Letter (Dec. 8, 1999). 40 See Proposing Release at n.9. Grounds for liability would continue to include (among others) violations of Section 34(b) of the Investment Company Act (which prohibits the making of any untrue statements of material fact in a registration statement, application, report, account, record or other document filed or transmitted pursuant to the Investment Company Act), Rule 22c-1 under the Investment Company Act (which governs funds' pricing of their redeemable securities), Section 206 of the Advisers Act (which contains the Act's antifraud provisions), and Rule 10b-5 under the Exchange Act (the Exchange Act's antifraud rule). 41 See Appendix A for one potential formulation. Ms. Vanessa A. Countryman July 16, 2020 Page 14 failure to comply with the rule would create no presumption of a statutory violation. This is appropriate, because there is no exclusive way to establish compliance with this statutory requirement, as decades of varied and evolving industry practice have shown. Yet we also recognize that industry practice likely would overwhelmingly conform to the requirements of a fair value safe harbor rule, because of the legal and compliance-related certainty that it would provide. As we have seen with other SEC safe harbor rules (including Regulation D, discussed below), the SEC's objective of establishing a "consistent framework"<sup>42</sup> still would be achieved. The SEC has adopted safe harbor rules in analogous situations, where a rule relates to a statutory term or concept that is not easily defined and may require analysis of specific facts and circumstances. A prominent example of this is Regulation D under the Securities Act, compliance with which assures the issuer that its private securities offering is within Section 4(a)(2), the Securities Act provision that exempts from registration transactions by an issuer not involving any public offering.<sup>43</sup> If this rule is not adopted as a safe harbor, one easily can envision a scenario where a board or adviser fails to comply with a particular rule element, yet still skillfully and appropriately carries out its fair value responsibilities in good faith and does no harm to the fund or its shareholders. Such technical non-compliance with a prescriptive rule element should not be deemed a failure to determine fair value in good faith. If the Commission does not adopt this rule as a safe harbor, alternatively it should: □ adopt a less prescriptive rule with a greater emphasis on principles and standards; and □ clearly state in any adopting release that any SEC enforcement actions related to fair valuation require a finding that the statutory "good faith" standard was not met, and that technical non-compliance with the rule, by itself, would not establish such a failure. In its 2017 interpretive guidance on pay ratio disclosures to operating companies, the SEC stated: "In light of the use of estimates, assumptions, adjustments, and statistical sampling permitted by the rule, pay ratio disclosures may involve a degree of imprecision. This has led some commenters to express concerns about compliance uncertainty and potential liability. In our view, if a registrant uses reasonable estimates, assumptions or methodologies, the pay ratio and related disclosure that results from such use would not provide the basis for Commission 42 Proposing Release at 14-15. 43 Rule 500(c) under the Securities Act states that "an issuer's failure to satisfy all the terms and conditions of rule 506(b) (§ 230.506(b)) shall not raise any presumption that the exemption provided by section 4(a)(2) of the Act (15 U.S.C. 77d(2)) is not available." Ms. Vanessa A. Countryman July 16, 2020 Page 15 enforcement action unless the disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith."<sup>44</sup> This rationale underlying the Commission's guidance on pay ratio disclosures also

clearly applies to funds' fair value determinations. IV. Additional Comments on the Proposal

We comment on several discrete aspects of the proposal below. A. Designate Additional Permissible Assignees We support permitting sub-advisers to assume fair value responsibilities, in whole or in part (i.e., the SEC should permit a board, an adviser, and a sub-adviser to allocate responsibilities among themselves however they see fit).<sup>45</sup> In addition, the SEC should permit the following entities to assume fair value responsibilities: □ Fund administrators (i.e., entities that provide administrative services, including fund accounting, to funds), which may be distinct from investment advisers and play a key role in the fair value process; □ Affiliated persons of a fund's investment adviser or administrator, in which valuation functions also may reside; and □ Committees comprised of personnel or officers of the fund,<sup>46</sup> an investment adviser, and/or a fund administrator. Current organizational structures are more varied than the proposal appears to presume, and without these changes many funds will incur greater costs to comply with the rule. This more expansive approach would permit all fund complexes to access valuation expertise that may not reside entirely within investment advisers. And adopting an expanded definition with a provision similar to the liquidity rule's definition of "program administrator"<sup>47</sup> would be especially useful to smaller fund

44 Commission Guidance on Pay Ratio Disclosure, SEC Release No. 33-10415, 82 Fed. Reg. 44917 (Sept. 27, 2017), available at [www.gpo.gov/fdsys/pkg/FR-2017-09-27/pdf/2017-20632.pdf](http://www.gpo.gov/fdsys/pkg/FR-2017-09-27/pdf/2017-20632.pdf). 45 Any adopting release should not, however, suggest any preferred approach to allocation of fair value responsibilities. 46 Permitting fund personnel and officers to carry out fair value responsibilities is a necessary accommodation for the small number of funds that are internally-managed. 47 See Rule 22e-4(a)(13) ("Person(s) designated to administer the program means 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..."). See also Investment Company Liquidity Risk Management Programs Frequently Asked Questions ("Liquidity Rule FAQs"), FAQs 1 through 4, available at [www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq](http://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq).

Ms. Vanessa A. Countryman July 16, 2020 Page 16 complexes and series trusts (i.e., trusts consisting of multiple funds, each with its own investment adviser), which would have additional means to ensure that portfolio managers do not exert undue influence on the fair value process. Finally, the SEC should state in any adopting release that boards retaining fair value responsibilities and assignees may seek assistance from other parties to discharge their duties. For instance, a board retaining these responsibilities could seek assistance from the fund's investment adviser or administrator, and an investment adviser/assignee could seek assistance from other entities (e.g., it could consult on an ad hoc basis with a sub-adviser, or seek ministerial assistance from a fund administrator).<sup>48</sup> Put another way, the SEC should recognize that parties other than those named in the rule (i.e., fund boards, advisers, and pricing services) may assist in the fair value process. B. Reaffirm Permissibility of Deviations in Methodologies, Inputs, and Resulting Fair Value Determinations from Fund to Fund We believe the proposal's emphasis on "consistency," especially in connection with the rule's provision on establishing and applying fair value methodologies, is misplaced. Any treatment of this topic in rule text or guidance is more likely to confuse and impair valid fair value practices than to improve them. Contrary to the statement in the Proposing Release,<sup>49</sup> valuation is not always carried out by applying a single pre-determined methodology to all assets within a class. For instance, a fund may apply different methodologies to: □ private equity investments depending on their industry, capital structure, "life cycle stage," and any other number of factors; □ the same investment over time as circumstances warrant, e.g.: o a bond experiencing a default or change in its credit rating; o an investment whose underlying market temporarily closes

(e.g., a foreign equity); or an investment that a pricing service begins covering after the fund acquires it (prior to which, the fund applied its own methodology); or the same investment at a specific point in time (e.g., stock in a company acquired before its initial public offering (IPO) may be valued differently from stock in the same company acquired following the IPO, if the pre-IPO shares are subject to lock-up provisions).<sup>48</sup> We understand that funds also may seek assistance or appraisals from consultants or valuation experts for complex securities or private equity investments.<sup>49</sup> Proposing Release at n.46 (“this requirement [i.e., applying a methodology consistently] would not require that a single methodology be applied in all cases, but instead that any methodologies selected be applied consistently to the asset classes for which they are relevant.”). Ms. Vanessa A. Countryman July 16, 2020 Page 17 The Proposing Release itself recognizes that consistency over time is not always appropriate.<sup>50</sup> Further, the Proposing Release suggests that multi-manager funds whose advisers have been assigned fair value responsibilities must “reconcile” differing opinions.<sup>51</sup> But this notion of “reconciliation” is hard to square with prior statements in the Proposing Release, with which we strongly concur: “We recognize, however, that there is no single methodology for determining the fair value of an investment because fair value depends on the facts and circumstance of each investment, including the relevant market and market participants. ... We continue to believe that for any particular investment there may be a range of appropriate values that could reasonably be considered to be fair value, and whether a specific value should be considered fair value will depend on the facts and circumstances of the particular investment. Accordingly, we expect that the methodologies used may reflect this range of potential fair values and result in unbiased determinations of fair value within the range.”<sup>52</sup> Given the nature of valuation, even the most informed, sophisticated, and rigorously-applied methodologies will not always yield a single “correct” figure. Moreover, requiring anything more concrete would be inconsistent with the very notion of the statute’s good faith standard, which the SEC staff has aptly called a “flexible concept.”<sup>53</sup> This, together with the welcome latitude the proposal would provide to boards and advisers in allocating fair value responsibilities, means that deviations in methodologies, inputs, and the resulting fair value determinations will be inevitable across—and even within—fund complexes.<sup>54</sup> Thus, a fund complex with a single board and multiple funds may very well employ different methodologies that yield different fair value determinations for its funds. We request that the SEC clearly re-affirm these points in any adopting release.<sup>55</sup>

<sup>50</sup> Proposing Release at nn. 50 through 52 and accompanying text. <sup>51</sup> Proposing Release at n.83 and accompanying text. <sup>52</sup> Proposing Release at 20, 22. <sup>53</sup> See supra, note 39 and accompanying text. <sup>54</sup> Cf. Investment Company Liquidity Disclosure, SEC Release No. IC-33142 (June 28, 2018) (amending Form N-PORT to permit a fund to classify the same portfolio investment differently if it has multiple sub-advisers with differing liquidity views) and Liquidity Rule FAQs 5 through 7. <sup>55</sup> Doing so also would provide certainty that the Commission is modifying the prior staff view “that a board could not arrive at different fair valuations for identical securities held by two or more funds that the board oversees, consistent with its good faith obligation.” See supra, note 39, at n.16. Ms. Vanessa A. Countryman July 16, 2020 Page 18 C. Provide Funds Flexibility to Test Fair Value Methodologies We support the Commission permitting the fund to exercise discretion as to the type and frequency of testing. As the Proposing Release notes, back-testing may be less useful for investments that trade infrequently, a common characteristic of most investments within the rule’s scope. As a practical matter, we anticipate that the availability of hard trading data will be an important factor in determining the frequency and scope of testing, and the SEC should explicitly recognize this in any adopting release.<sup>56</sup> Also, the SEC should clarify that parties other than the adviser may perform testing. For instance, we understand that pricing services regularly test their fair value adjustments for foreign equities and report the results to their clients.

Funds commonly adjust the last-traded prices on the foreign exchanges to account for market events and time zone differences when they value their holdings as of 4:00 pm Eastern Time. Requiring funds to perform similar testing therefore would be redundant. In other cases, testing performed at the fund complex may yield little useful information. Suppose, for instance, that a fund complex has only one fixed income fund, which invests in approximately 200 municipal bonds and experiences very little portfolio turnover. Any fund-specific valuation testing would be severely limited. By contrast, any testing results from a service that prices municipal bonds for the fund could potentially capture data for thousands of municipal bond trades, and be far more comprehensive and illuminating for both the adviser and the board.

D. Provide Flexibility for Challenging Evaluated Prices Along with requiring oversight of pricing services, the proposed rule would require a fund to establish “[c]riteria for initiating price challenges,” and the Proposing Release suggests that establishing objective thresholds would be a way of doing so. In this respect, the proposal does not accurately capture the price challenge process, in part because it does not fully appreciate its benefits. To the extent that price challenges improve the precision of a pricing service’s prices and aids price discovery, this activity benefits all entities using that pricing service and demonstrates quality vendor oversight. This is especially important in stressed market conditions, such as those of March 2020. Anecdotally, members have indicated that pricing services experienced a 56% increase in price challenges during that month. As noted above and in Appendix A, we recommend that any testing results be reported to the board annually. If the SEC does not take this comment, then at a minimum it should clarify that advisers must report testing results only if they have them for a given quarter (i.e., this quarterly board reporting item under paragraph (b) does not create a de facto obligation to test quarterly under paragraph (a)). Also, we would object to requiring funds to compare their prices to those of a “second source” (i.e., a second vendor- provided price or a quote from a dealer) as part of the testing obligation (see Proposing Release at n.58). Some funds use these methods as part of their testing, but the costs and challenges of obtaining this information (e.g., obtaining dealer quotes as a matter of course can be difficult) make it impracticable for all fund complexes and across all assets.

Ms. Vanessa A. Countryman July 16, 2020 Page 19

significant increase in price challenges during that month. This shows both advisers’ heightened scrutiny of evaluated prices and the potential pitfalls of an overly rigid price challenge process, which could have resulted in an even more price challenges (many potentially meritless) during the period. Fair value pricing is challenging in stressed and volatile market conditions, but active and informed engagement between pricing services and investment advisers and other market participants improves the overall process and quality of prices that pricing services disseminate. The price challenge process cannot be reduced to a mechanical set of rules or criteria—often, advisers exercise judgment and discretion in determining which evaluated prices to challenge. Doing so means the challenge process is dynamic and responsive to ever-changing facts and circumstances. For the Commission to require something more specific risks creating a sub-optimal price challenge process that would be both underinclusive (advisers could be prevented from challenging suspect prices that do not qualify under pre-set criteria) and overinclusive (advisers may feel compelled to challenge prices based on those criteria, even if they do not otherwise believe that the evaluated price is unreasonable, imposing burdens on the adviser and the pricing service). Furthermore, price challenges that do not include trading data to support the challenge typically do not result in changes to the previously-disseminated prices and thus are not productive. We therefore recommend modifying the proposed provision on price challenges to require instead the establishment of a “process for initiating price challenges.” Also, any final adopting release must be abundantly clear that any board reporting obligation here is limited to summary information of price overrides only,<sup>57</sup> which would provide boards with relevant information on such activity

and trends without burdening them with extraneous data. Finally, as discussed above in Section III.B, price challenges and overrides should have no connection to any mandated “prompt” board reporting,<sup>57</sup> We do not recommend modifying the proposed rule text, but certain statements in the Proposing Release are unclear and potentially inconsistent. For instance, the Proposing Release states that a fund board “could review and consider, if relevant: Summaries ... of price overrides,” even though the rule text explicitly requires this. (Proposing Release at 46, emphasis added.) Elsewhere, the Proposing Release states, “We are proposing to require that all price overrides be reported as supplemental information to the board as part of the periodic report.” (Proposing Release at 48, emphasis added.) This could be interpreted as requiring something more than summary information. Finally, footnote 109 and its accompanying text appear to conflate the distinct concepts of price challenges and price overrides, by suggesting that the former is a required reporting item. Ms. Vanessa A. Countryman July 16, 2020 Page 20 because of the number of false positives and related distractions (for both boards and advisory personnel) that such an overly-broad requirement would generate during stressed market conditions.<sup>58</sup> E.

**Additional Auditing- and Accounting-Related Comments** We support eliminating the requirement in ASR 118 for the fund’s independent accountant to verify all security values at the balance sheet date.<sup>59</sup> Without this requirement, fund auditors instead would apply PCAOB audit standards, which permit sampling and other techniques to verify the values of securities owned. The PCAOB recently adopted a comprehensive update to its audit standards relating to auditing fair value measurements, and the SEC approved that updated audit standard.<sup>60</sup> We believe rescinding the 100 percent verification requirement may afford fund auditors flexibility and efficiencies in performing fund audits without sacrificing investor protections. The proposal also seeks comment on whether investments in pooled vehicles, such as registered investment companies that are valued at NAV per share rather than market price, should be treated as fair values subject to the proposed rule’s requirements. ASC Topic 820-10-20 indicates that an “equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity)” has a “readily determinable fair value” if “the fair value per share (unit) is determined and published and is the basis for current transactions.” We believe any mutual fund that publishes its NAV daily and issues and redeems shares at that NAV would be considered a Level 1 security and have a readily available market quotation under the proposal. Similarly, any pooled vehicle (e.g., an internal cash fund offered to other funds in the complex) that calculates and disseminates to shareholders its NAV daily and issues and redeems shares at that NAV should be considered a Level 1 security and have a readily available market quotation under the proposal. F. Unit Investment Trusts The proposal recognizes that UITs differ structurally from other fund types,<sup>61</sup> and therefore would require the UIT’s trustee to carry out the rule’s requirements (a UIT does not have a board or an

<sup>58</sup> See Letter from Thomas Kim, Managing Director, Independent Directors Council, to Vanessa Countryman, Secretary, SEC, at 8, dated July 16, 2020.

<sup>59</sup> The rescission would not affect the independent accountant’s obligation under Section 30(g) of the Investment Company Act to verify the existence and ownership of securities, either by actual examination or receipt of a certificate from the fund’s custodian.

<sup>60</sup> Auditing Accounting Estimates, Including Fair Value Measurements, PCAOB Release No. 2018-005 (Dec. 20, 2018). The Commission subsequently approved the audit standard. See SEC Order Granting Approval of AS 2501, SEC Release No. 34- 86269 (July 1, 2019). The audit standard is effective for fiscal years ending on or after December 15, 2020.

<sup>61</sup> Section 4(2) of the Investment Company Act defines a UIT as an investment company that (i) is organized under a trust indenture or similar instrument; (ii) does not have a board of directors; and (iii) issues only redeemable securities, each of Ms. Vanessa A. Countryman July 16, 2020 Page 21 investment adviser). Generally speaking, a UIT’s trust

indenture designates a depositor (also known as the sponsor), a trustee, and an evaluator. The depositor is generally responsible for assembling the trust's portfolio and distributing the trust's units during an initial offering period.<sup>62</sup> The trustee, which must be a bank under the Investment Company Act,<sup>63</sup> keeps custody of the trust's securities and maintains the accounts and record of the trust. The evaluator values the trust's securities. We believe that in most cases the evaluator—often (but not always) an affiliate of the depositor—would be better positioned to determine fair value for UITs. We understand that the evaluator hires a pricing service to provide prices for the trust's securities, subject to an initial due diligence and continuing oversight process similar to that performed by fund advisers. We note that evaluators generally are compensated based on the number of units (and not the value of the trust's net assets), and therefore they (or their affiliates) would have no incentive to overstate the value of the trust's securities to increase their fees. We also note that, because of their fixed terms, holding Level 3 securities within UITs is rare, which limits UITs' valuation-related risks. For these reasons, we recommend amending the rule text to permit not only trustees,<sup>64</sup> but also depositors, affiliated persons of trustees or depositors, or third-party service providers to carry out fair value responsibilities.

**G. Effects of the Proposed Rule on Cross-Trading** The SEC should clarify in any adopting release that this final rule (particularly its definition of "readily available market quotations") does not affect funds' current cross-trading practices. Funds may enter into a cross-trade in reliance on Rule 17a-7 only if the "transaction is a purchase or sale... of a security for which market quotations are readily available." However, the SEC staff has issued no-action letters which represents an undivided interest in a unit of specified securities. Depositors typically create UITs by accumulating a fixed portfolio of equity or debt securities for deposit with a trustee under the terms of a trust indenture between the depositor, the trustee, and certain other parties. The trust then issues participation units in the portfolio and offers the units to the public at an offering price based on the value of the underlying securities plus a sales charge. A distinguishing feature of UITs relative to other fund types is that their portfolios are unmanaged (i.e., the UIT has no investment adviser and the portfolio generally remains fixed over the life of the trust). <sup>62</sup> The sponsor may also maintain a market for the units after the initial offering period and continually offer to purchase units at prices based on the redemption price per unit. <sup>63</sup> Section 26(a) of the Investment Company Act. <sup>64</sup> We also note that current SEC guidance permits trustees and their appointed persons to carry out fair value responsibilities, and thus adopting paragraph (d) as proposed would reduce UITs' regulatory flexibility in this regard. See Form N-7 for Registration of Unit Investment Trusts under the Securities Act of 1933 and the Investment Company Act of 1940, SEC Release No. IC-15612, 52 FR 8268, 8295-96 (Mar. 17, 1987). Ms. Vanessa A. Countryman July 16, 2020 Page 22 permitting funds to cross-trade municipal securities using vendor prices, notwithstanding the absence of readily available market quotations.<sup>65</sup> While funds value the ability to rely on these staff no-action letters, we believe that Rule 17a-7 is ripe for modernization.<sup>66</sup> The rule's terms have precluded fund complexes from entering into cross-trades (particularly for fixed income investments) that would be mutually beneficial.<sup>67</sup> In fact, the SEC's Fixed Income Market Structure Advisory Committee recently found that Rule 17a-7's conditions "make it difficult to impossible to cross trade fixed income securities" and recommended ways to facilitate beneficial cross trading activity. Unless and until the SEC amends it, the Commission should at a minimum affirm the guidance in these existing staff no-action letters and ensure that Rule 2a-5 does not interfere with existing cross-trading activity.

**H. Compliance Period** We recommend an 18-month compliance period, rather than the proposed 12-month period. Valuation is a critically important daily fund function that is data-intensive and requires careful coordination within and outside a fund complex. Updating valuation policies, procedures, and practices will require collaboration internally (across multiple firm functions, including

fund accounting, operations, legal, compliance, information technology) and externally (e.g., with pricing services, fund administrators, and fund custodians). Funds need ample time to implement changes (and if necessary, test those changes) before they can confidently incorporate them into the daily valuation workflow. The additional time will be especially necessary if the SEC adopts any other significant rules or guidance close in time to finalizing this rule.<sup>68</sup> ■ ■ ■ ■ ■ 65 See United Municipal Bond Fund, SEC Staff No-Action Letter (Jan. 27, 1995) and Federated Municipal Funds, SEC Staff No-Action Letter (Nov. 20, 2006). 66 See Preliminary Recommendation Regarding Modernizing Rule 17a-7 under the 1940 Act, (June 1, 2020), available at [www.sec.gov/spotlight/fixed-income-advisory-committee/preliminary-recommendation-re17a-7.pdf](http://www.sec.gov/spotlight/fixed-income-advisory-committee/preliminary-recommendation-re17a-7.pdf). 67 Specifically, the rule's scope and its requirement that fixed income securities be priced at "the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry" have limited funds' ability to enter cross-trades. 68 See, e.g., 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, SEC Release No. 34-87607 (Nov. 25, 2019). Ms. Vanessa A. Countryman July 16, 2020 Page 23 If you have any questions, please contact me at 202-326-5813; Gregory Smith, Senior Director, Fund Accounting and Compliance at 202-326-5851; Dorothy Donohue, Deputy General Counsel at 202- 218-3563; or Matthew Thornton, Assistant General Counsel at 202-371-5406. Sincerely, /s/ Susan Olson General Counsel Investment Company Institute cc: The Honorable Jay Clayton The Honorable Hester M. Peirce The Honorable Elad L. Roisman The Honorable Allison Herren Lee Dalia O. Blass, Director Division of Investment Management Sagar Teotia, Chief Accountant Office of the Chief Accountant A-1 Appendix A: ICI's Recommended Amendments to Rule 2a-5 (marked to show changes) § 270.2a-5 Fair value determination and readily available market quotations. Note: This section is a non-exclusive safe harbor that provides one approach for satisfying the definition of "value" (particularly "fair value as determined in good faith by the board of directors") for purposes of section 2(a)(41) of the Act (15 U.S.C. 80a2(a)(41)) and § 270.2a-4. The section is not intended, however, to create any presumption about any activity (or omissions) of a fund, fund board, or an Assignee (or any entity that determines fair value on behalf of a unit investment trust) related to determining fair value in good faith that is not carried out in the manner contemplated by the section. (a) Fair value determination. For purposes of section 2(a)(41) of the Act (15 U.S.C. 80a2(a)(41)) and § 270.2a-4, determining fair value in good faith with respect to a fund requires will be deemed to have occurred where the board of the fund or an Assignee: (1) Assess and manage risks. Periodically assesses any material risks associated with the determination of the fair value of fund investments ("valuation risks"), including material conflicts of interest, and managing those identified valuation risks; (2) Establish and apply Determine fair value methodologies. Performing. Performs each of the following, taking into account the fund's valuation risks: (i) Selecting and applying in a consistent manner an appropriate methodology or methodologies for determining (and calculating) the Establishes how fair value of fund determinations could be made for its portfolio investments, including specifying: (A) The key inputs and assumptions specific to each asset class or portfolio holding; and (B) Which methodologies apply to new types of fund investments in which a fund intends to invest; (ii) Periodically reviewing the appropriateness and accuracy of the methodologies selected and making any necessary adjustments thereto; (iii) Monitoring Monitors for circumstances that may necessitate the use of fair value; and (iv) Establishing (iii) Establishes criteria for determining when market quotations are no longer reliable; (3) Review and test fair value methodologies. Reviews and provides for testing the appropriateness and accuracy of the fair value methodologies that have been selected,



including identifying the testing methods to be being used and the, including by determining the means of testing, the party to perform it, and its minimum frequency with which such testing methods are used, and make any necessary adjustments to how the fund determines fair value; A-2 (4) Evaluate pricing services. OverseeingOversees pricing service providers, if used, including by establishing: (i) The process for the approval, monitoring, and evaluation of each pricing service provider, and (ii) CriteriaA process for initiating price challenges; (5) Fair value policies and procedures. AdoptingAdopts and implementingimplements written policies and procedures addressing the determination of the fair value of fund investments that are reasonably designed to achieve compliance with the requirements described in paragraphs (a)(1) through (4) of this section; and (6) Recordkeeping. MaintainingMaintains: (i) Appropriate documentationFor those investments for which the fund typically relies on a pricing service to support fair value determinations, provide prices, those prices received from the pricing service, along with the basis for any adjustments made to them, for at least five years after receipt or adjustment, the first two years in an easily accessible place; (ii) For those investments for which the fund (including the fund board or any Assignee) establishes and applies its own methodologies, information regarding the specific methodologies applied and the key assumptions and inputs considered when making fair value determinations, as well as any necessary or appropriate adjustments in methodologies, for at least five years from the time the determination was made, the first two years in an easily accessible place; and (iii) A copy of policies and procedures as required under paragraph (a)(5) of this section that are in effect, or were in effect at any time within the past five years, in an easily accessible place. (b) Performance of fair value determinations. The board of the fund must determine fair value in good faith for any or all fund investments by carrying out the functions required in paragraph (a) of this section. The board may choose to assign the fair value determination (or any and all related tasks and responsibilities) relating to any or all fund investments to an investment adviser of the fundone or more Assignees, which would carry out all of the functions required in paragraphs (a)(1) through (5) of this section, subject. In that case, the board shall be deemed to the requirements ofhave satisfied its obligation to determine fair value in good faith, when the steps specified in this paragraph (b).) are taken. If the board of the fund does not assign fair value determinations to an adviser to the fundAssignee, the fund must adopt and implement the policies and procedures required under paragraph (a)(5) of this section and maintain the records required by paragraph (a)(6) of this section. (1) Oversight and reporting. The board oversees the adviserAssignee, and the adviserAssignee reports to the fund's board, in writing, including such information as may be reasonably necessary for the board to evaluate the matters covered in the report, as follows: A-3 (i) PeriodicAnnual reporting. At least quarterlyannually, an assessment of the adequacy and effectiveness of the investment adviser'sAssignee's process for determining the fair value of the assigned portfolio of investments, including, at a minimum, a summary or description of: (A) The assessment and management of material valuation risks required under paragraph (a)(1) of this section, including any material conflicts of interest of the investment adviserAssignee (and any other key service provider); (B) Any material changes to, or material deviations from, the fair value methodologies establisheddetermined under paragraph (a)(2) of this section; (C) The results of the testing of fair value methodologies required under paragraph (a)(3) of this section; (D) The adequacy of resources allocated to the process for determining the fair value of assigned investments, including any material changes to(D) The roles or functions of the persons responsible for determining fair value under paragraph (b)(2) of this section, and the material changes thereto during the reporting period; (E) Any material changes to the adviser'sAssignee's process for selecting and overseeing pricing services, as well as material events related to the adviser'sAssignee's oversight of pricing services (such as changes in the service providers

used or price overrides); and (F) Any other materials requested by the board related to the adviser's Assignee's process for determining the fair value of assigned investments; and (ii) Prompt Quarterly board reporting. The adviser reports promptly (but in no event later than three business days after the adviser becomes aware At least quarterly, a description of the matter) on matters associated with the adviser's process any material change to or occurrence of the following, that materially affect or could have materially affected the had not been reported previously to the board under paragraph (b)(1)(i) or (ii): (A) Valuation risks; (B) Fair value of the assigned portfolio of investments, including any methodologies applied by the Assignee, or any material deviations therefrom; and (C) Any significant deficiency or material weakness in the design or implementation of the adviser's Assignee's fair value determination process or material changes in the fund's valuation risks under paragraph (a)(1) of this section as verified during the quarter; (2) Specify responsibilities. The adviser Assignee specifies the titles of the persons responsible for determining the fair value of the assigned investments, including by specifying the particular functions A-4 for which they are responsible, and reasonably segregates the process of making fair value determinations from the portfolio management of the fund; (if applicable); and (3) Records when assigning. In addition to the records required in paragraph (a)(6) of this section, the fund maintains copies of: (i) The reports and other information provided to the board as required under paragraph (b)(1) of this section; and (ii) A specified list of the investments or investment types whose fair value determination has been assigned to the adviser Assignee pursuant to this paragraph (b), in each case for at least five years after the end of the fiscal year in which the documents were provided to the board or the investments or investment types were assigned to the adviser Assignee, the first two years in an easily accessible place. (c) Readily available market quotations. For purposes of section 2(a)(41) of the Act (15 U.S.C. 80a-2(a)(41)), 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. (d) Unit investment trusts. If the fund is a unit investment trust, the fund's trustee must carry out the requirements of paragraph (a) must be carried out by the fund's trustee, depositor, an affiliated person of this section the trustee or the depositor, or any other service provider that is not an affiliated person of the trustee or depositor. (e) Definitions. For purposes of this section: (1) Fund means a registered investment company or business development company. (2) Fair value means the value of a portfolio investment for which market quotations are not readily available under paragraph (c) of this section. (3) Board means either the fund's entire board of directors or a designated committee of such board composed of a majority of directors who are not interested persons of the fund. (4) Assignee means: (i) an investment adviser or administrator of the fund; (ii) any affiliated person of an investment adviser or administrator of the fund; or (iii) a committee comprised of personnel or officers of the fund and/or one or more entities specified in (i) or (ii).