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July 21, 2020

Vanessa Countryman
Secretary
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Good Faith Determinations of Fair Value
File No. S7-07-20

Dear Ms. Countryman:

The Asset Management Group ("**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to provide comments to the United States Securities and Exchange Commission (the "**Commission**") on the Commission's proposed new Rule 2a-5 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**" or the "**1940 Act**"), that would address valuation practices and the role of the board of directors with respect to the fair value of the investments of a registered investment company or business development company (a "**fund**") (the "**Proposed Rule**"). In addition, AMG is also providing comments on the Commission's proposal to rescind previously issued guidance on the role of a fund's board in determining fair values and other aspects of the Proposing Release (together with the Proposed Rule, the "**Proposal**").[2]

AMG generally supports the object of the Proposed Rule – to specify how a board or registered investment adviser acting at the direction of a board ("**adviser**") must make good faith determinations of fair value, as well as when the board can assign this function to an adviser, while still ensuring that fund investments are valued in a way consistent with the 1940 Act. To assist the Commission in finalizing the Proposed Rule, AMG will address the following matters:

(i) board reporting;

[1] SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit http://www.sifma.org/amg.

[2] Good Faith Determinations of Fair Value, Release No. IC-33845 (April 21, 2020), Federal Register 85:93 (May 13, 2020) p. 28734, available at https://www.govinfo.gov/content/pkg/FR-2020-05-13/pdf/2020-08854.pdf (the "**Proposing Release**").

(ii) price challenges;

(iii) the impact of recent adverse market conditions;

(iv) the importation of U.S. generally-accepted accounting principles ("**U.S. GAAP**") into a rule under the 1940 Act;

(v) the rescission of existing guidance on fair valuation; and

(vi) other topics, including the role of sub-advisers, striking the right balance on assignment, compensation, back-testing, and fair value methodologies.

A. Background

Overview of Valuation.

Under the 1940 Act, funds are required to value their portfolio investments using the market value of their portfolio securities when market quotations for those securities are "readily available" and, when market quotations are not readily available, by using the fair value of those securities, as determined in good faith by the fund's board.[3] Valuation impacts the price at which fund shares are offered, redeemed and/or repurchased, as well as asset-based and performance-based fee calculations, disclosures, and compliance with investment policies and limitations, including the 15% limitation on illiquid investments.[4] Accordingly, for these and other reasons, including related accounting and financial reporting matters, proper valuation is a critical component of the day-to-day operations of a fund.

Current Legal Landscape.

The Proposing Release provides an overview of Commission rules and regulations relating to determinations of fair value. Prior to 1970, in a pair of accounting releases, the Commission acknowledged, among other things, that the board "need not itself perform each of the specific tasks required to calculate fair value in order to satisfy its obligations under Section 2(a)(41) of the Investment Company Act."[5] According to the Commission, three subsequent regulatory developments have altered valuation practices. First, the enactment of the Sarbanes-Oxley Act of 2002 ("**Sarbanes-Oxley Act**") led to the establishment of the Public Company Accounting Oversight Board ("**PCAOB**"), which, very generally, oversees the audits of companies subject to the federal securities laws.[6] Rule 30a-3 under the 1940 Act was adopted to implement certain requirements under the Sarbanes-Oxley Act and requires funds to maintain certain disclosure controls and procedures and internal controls over financial reporting.[7] Second, compliance rules under the 1940 Act and the Investment Advisers Act of 1940 were adopted in 2003. Rule 38a-1 under the 1940 Act requires a fund to adopt compliance policies and procedures with respect to fair value to, among other things, monitor for circumstances that may necessitate fair value, establish certain criteria for determining when market quotations are no longer reliable,

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[3] Section 2(a)(41) of the 1940 Act.

[4] *See* Rule 22e-4(b)(1)(iv) under the 1940 Act.

[5] *See* Proposing Release at 9. The accounting releases are Accounting Series Release 113 (Oct. 21, 1969) ("**ASR 113**") and Accounting Series Release 118 (Dec. 23, 1970) ("**ASR 118**").

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

[7] *See* Investment Company Act Release No. 25914 (Jan. 27, 2003) (adopting Investment Company Act Rule 30a-3).

and provide a methodology by which a fund determines fair value.[8] Finally, in Accounting Standard Codification Topic 820: *Fair Value Measurement* ("**ASC Topic 820**"),[9] which was issued and codified by the Financial Accounting Standards Board ("**FASB**") in 2006 and 2009,[10] the term "fair value" is defined for purposes of accounting standards[11] and a framework for the recognition, measurement, and disclosure of fair value under U.S. GAAP is established. In the Proposing Release, the Commission recognizes that funds are now able to invest in a greater variety of securities and other instruments that may not have existed in 1970 and that boards and advisers today have different and more significant valuation challenges than may otherwise have presented themselves over fifty years ago.[12] One significant purpose of the Proposed Rule is to aggregate the various modern principles applicable to fair valuation determinations into a single, comprehensive rule.

The Proposal.

The Proposed Rule would permit a fund's board[13] to formally assign fair value determinations to the fund's adviser. If a fund's board formally assigns fair value determinations to a fund's adviser, the adviser would be subject to board oversight and detailed reporting, recordkeeping and other requirements intended to enhance the board's oversight of the adviser's fair value determinations. Regardless of whether a fund's board assigns fair value determinations to a fund's adviser, the Proposed Rule would prescribe detailed requirements for determining fair value. The Proposed Rule also would define the criteria for concluding that a market quotation is "readily available," which is currently not defined in the 1940 Act and the rules thereunder.

Requirements to Determine Fair Values.

The Proposed Rule would provide that the overall program used to determine the fair value of a fund's portfolio investments must include:

(i) assessing and managing material risks associated with fair value determinations;

(ii) selecting, applying and periodically assessing fair value methodologies;

(iii) testing the appropriateness and accuracy of the fair value methodologies that have been selected;

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[8] *See* 17 CFR § 270.38a-1.

[9] The former FAS 157 became known as ASC Topic 820 upon the codification of Generally Accepted Accounting Principles, which became effective for reporting periods ending after September 15, 2009.

[10] The FASB issued Fair Value Measurements, Statement of Financial Accounting Standards No. 157 ("**SFAS No. 157**"), in September 2006, and codified it in 2009 as ASC Topic 820.

[11] In the Proposing Release and this letter, unless otherwise noted, the term "fair value" is used as that term is used in the definition of "value" in the 1940 Act, meaning the value of securities for which no readily available market quotations exist. ASC Topic 820, on the other hand, uses the term "fair value" to refer generally to the value of an asset or liability, regardless of whether that value is based on readily available market quotations or on other inputs. *See* Proposing Release at n. 13.

[12] *See* Proposing Release at 9-10, 14.

[13] For purpose of the Proposed Rule, "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. *See* Proposed Rule 2a-5(e)(3). With respect to unit investment trusts ("**UITs**"), a UIT's trustee would conduct fair value determinations under the Proposed Rule (because a UIT does not have a board of directors or investment adviser).

(iv) overseeing and evaluating any pricing services used;

(v) adopting and implementing policies and procedures reasonably designed to achieve compliance with the requirements of items (i) – (iv); and

(vi) maintaining documentation to support fair value determinations, including information regarding the specific methodologies applied and the assumptions and inputs considered.

Under the Proposed Rule, these elements would need to be addressed regardless of whether fair valuation is assigned to the adviser by a fund's board.

Assignment.

If a board assigns a fund's fair value determinations to the fund's adviser (which may include any sub-adviser that manages the fund or a portion thereof), the Proposed Rule would require the adviser to perform the functions and maintain the records listed in items (i) – (vi).[14] In addition, the Proposed Rule would subject the adviser to certain board oversight and reporting requirements described below.

Oversight and Reporting.

If a board assigns a fund's fair value determinations to the fund's adviser, the Proposed Rule also would require the board to oversee the adviser with respect to its fair value determinations and the adviser would be required to:

1. Inform the board in writing of the titles of the persons responsible for determining the fair value of the fund's portfolio holdings, including the particular functions for which they are responsible;

2. Reasonably segregate the fair valuation process from the fund's portfolio management;

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

4. Promptly report to the board in writing on matters associated with the adviser's fair valuation process that materially affect, or could have materially affected, the fair value of the fund's investments (in no event later than three business days after the adviser becomes aware of the matter); and

5. Maintain, in addition to the documentation specified in item (vi) above, the reports and other information provided to the board and a list of the investments whose fair value was determined by the adviser.

[14] If a fund's board does not assign fair value determinations to the fund's adviser, the Proposed Rule would require the fund to adopt and implement the policies and procedures required under item (v) and to maintain the records required by item (vi). *See* Proposed Rule 2a-5(b).

Definition of "Readily Available."

The Proposed Rule would provide that, for purposes of Section 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."[15] The Proposing Release adds that "a quote would be considered unreliable under [the Proposed Rule] in the same circumstances where it would require adjustment under U.S. GAAP or where U.S. GAAP would require consideration of additional inputs in determining the value of the security."[16] Thus, under the Proposed Rule, whether a quotation is "reliable" would turn on existing U.S. GAAP, and would equate the determination that market quotations are "not readily available" with the determination under U.S. GAAP that "otherwise relevant observable inputs become unreliable."

Rescission of Previously Issued Valuation Guidance.

Finally, if the Proposed Rule is adopted, the Commission plans to rescind a variety of previously issued guidance on the role of a fund's board in determining fair values.

Differences Between the Proposed Rule and Current Valuation Practices

In AMG's estimation, the Proposed Rule appears unlikely to impact the quality or efficiency in pricing of fair valued instruments held by funds. However, if adopted, it will require funds and their boards to conform their policies and procedures to comply with the highly prescriptive provisions of the Proposed Rule (e.g., the frequency and content of an adviser's reports regarding fair valuation matters), and will make reporting and recordkeeping significantly more burdensome. As the Commission has stated, the Proposed Rule would differ from the current regulatory framework because "it would mandate more specific fair value practices, policies and procedures, reporting, and recordkeeping requirements and those requirements would be explicitly imposed on funds and performed by boards or advisers."[17] AMG contends that the current oversight regime is already robust, and wholesale changes to fund valuation requirements should not be necessary.

B. AMG Comments

AMG observes that while the Proposed Rule seeks to enhance a board's oversight of an adviser's fair value determinations, assuming that fair value determinations are assigned to the adviser,[18] fund boards and advisers have always used, and will continue to use, their good faith judgment to determine fair values. As such, we note that the Proposed Rule would not change the fiduciary duties of boards and advisers with respect to good faith determinations of fair value. We fear, however, that the Proposed Rule's prescriptive requirements will eliminate the board's ability to appropriately exercise its business judgment in numerous aspects of its traditional role in overseeing fair value determinations. The structure and uniformity that the Proposed Rule seeks to provide will leave little room for boards to exercise their business judgment, and instead

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[15] *See* Proposing Release at 57-58.

[16] *See* Proposing Release at 58.

[17] *See* Proposing Release at 88.

[18] An informal poll of SIFMA members suggests that virtually all boards will assign fair value determinations to the adviser under the Proposed Rule.

requires more board reporting, significantly increased recordkeeping and less discretion – not about the valuation of fund investments, but about what information to receive and when. Below, we suggest a number of changes to make the Proposed Rule more principles based, ensuring an effective fair valuation framework while at the same time not disturbing effective existing practices and typical board prerogatives.

Committee Comments on Board Reporting.

AMG supports the Commission's goal of improving the flow of information between a fund board and any advisers to whom fair value determinations are assigned.[19] In order to fulfil the board's responsibility to determine the fair value of securities in good faith, AMG agrees it is crucial that boards receive valuation information that is tailored and relevant, and that the amount, type, and form of the information presented conform to that which the board finds most useful in overseeing the adviser.[20] Unfortunately, as currently drafted, the Proposed Rule does not strike the appropriate balance.

Under the Proposed Rule, advisers assigned fair value responsibilities would be required to (i) at least quarterly, provide the board with a written report assessing the adequacy and effectiveness of the adviser's process for determining the fair value of any assigned portfolio investments[21] (the "**periodic reporting requirement**"), and (ii) "promptly," but in no event later than three business days after the adviser becomes aware of the matter, provide the board with a written report on matters "associated with the adviser's process that materially affect or could have materially affected the fair value of the assigned portfolio investments"[22] (the "**prompt reporting requirement**"). These requirements would supplement any reports required under Rule 38a-1 under the 1940 Act.[23]

AMG is concerned that the frequency of reporting that would be required under the Proposed Rule, as well as the ambiguity presented in the prompt reporting requirement, will undermine the Commission's goal of establishing an effective information flow, overburden advisers and boards, especially during times of market volatility, and saturate board materials with information that, inevitably, will become boilerplate, making it harder for boards to exercise effective oversight over the fair valuation process. Instead of allowing boards and advisers to determine, as they often do today, what information is helpful and when to receive such information, the Proposed Rule prescribes both the content and timing of board reporting. This will constrain a board's ability to exercise its business judgment, and instead will encourage boards to focus disproportionately on mandated activities and reports to foreclose potential second guessing, but which will not result in improved oversight of valuation practices or improved valuations. Rather, we believe the board's role is one of general oversight, and not day-to-day management subject to prescriptive requirements. Set forth below are a number of comments relating to the anticipated impact of the periodic reporting requirement and the prompt

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[19] *See* Proposing Release at 41.

[20] *See* Proposing Release at 42.

[21] *See* Proposed Rule 2a-5(b)(1)(i).

[22] *See* Proposed Rule 2a-5(b)(1)(ii).

[23] *See* Proposing Release at n. 98.

reporting requirement, as well as recommendations for improving the flow of information between a fund board and the adviser.

Periodic Reporting Requirement.

The Proposed Rule's periodic reporting requirement would require an adviser to provide the board at least quarterly with a written report that summarizes or describes at least six topics. These topics cover, very generally:

> (1) the assessment and management of material valuation risks, including any material conflicts of interest of the adviser or any other service provider;
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> (2) any material changes or material deviations from the adviser's established fair value methodologies;
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> (3) the results of any testing of fair value methodologies;
>
> (4) the adequacy of resources allocated to the fair value process, including any material changes to the roles or functions of persons involved in that process;
>
> (5) any material changes to the adviser's process for overseeing pricing services; and
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> (6) any other materials related to the fair value process that the board requests.[24]

An informal poll of AMG members suggests that, of these required topics, few are expected to regularly change from quarter to quarter, such that the proposed quarterly report would not be meaningfully different from quarter to quarter. Instead, AMG suggests that these items should be reported upon annually or quarterly on an as needed basis.

AMG is concerned that the periodic reporting requirement would not supply boards with the information needed to fulfil their statutory and fiduciary duties, but instead would make it more difficult for boards to critically assess the information contained in such reports. It is also possible that this added volume of information, which is likely to supplement rather than replace most, if not all, of the information the board is already accustomed to receiving on a quarterly basis (such as lists of each individual holding that is fair valued and any related explanatory materials), will distract the board from exercising its oversight duties. AMG believes that rehashing these six topics on a quarterly basis would not achieve the goal of the Commission to "enable boards to focus on the inquiries that serve investors best."[25] Further, the expanded reporting requirements will also greatly increase the amount of records required to be maintained.

Substance of the Proposed Periodic Reports.

AMG observes that in the Proposing Release, in addition to the six topics discussed above, the Commission suggests that a board could review and consider, if relevant, nine additional categories of information, including:

- summaries of adviser price challenges to pricing information provided by pricing services,

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[24] *See* Proposed Rule 2a-5(b)(1)(i)(A)-(F).

[25] *See* Blass, Dalia, Director, Division of Investment Management, "Remarks at the IDC – 2018 Fund Directors Conference," (Oct. 16, 2018), available at https://www.sec.gov/news/speech/speech-blass-101618.

- specific calibration and back-testing data,
- reports regarding portfolio holdings for which there has been no change in price or for which investments have been held at cost for an extended time period ("**stale prices**"),
- reports regarding portfolio holdings whose price has changed outside of predetermined ranges over a set period of time,
- summaries or reports of pricing errors,
- due diligence on pricing services,
- results of testing by the fund's independent auditor provided to the audit committee,
- reports analyzing trends in fair valued securities, and
- reports on the number and materiality of securities whose fair values were determined base on information provided by broker-dealers.[26]

Not only does this laundry list diminish a board's ability to exercise judgment, but it also suggests that the adviser cannot be trusted to provide the board with information it believes relevant to its duties with respect to its fair valuation obligations. AMG is concerned that, over time, these additional categories of information will become *de facto* requirements in practice, either because boards will be concerned that not asking for these materials will result in potential liability or enforcement referrals arising out of the examination process. This would make it even more difficult for boards to consume all of this information quarterly and in a manner that is productive to their oversight duties.

These additional categories of information that the board could review and consider, if relevant, also serve as a good example of how the Proposed Rule may result in over-reporting to the board. One of these categories would include "summaries of adviser price challenges to pricing information provided by pricing services and of price overrides, including back-testing results related to the use of price challenges and overrides."[27] AMG believes that the Commission does not intend for certain types of overrides, such as systematic price adjustments for foreign securities, to get picked up under the prompt reporting requirement. As detailed in the "Price Challenges under the Proposed Rule" section, below, we note that price challenges and price overrides are not inherently problematic, and they often may signal a well-functioning fair valuation process.

For these reasons, AMG recommends that these nine additional categories of information be removed from the Proposal.

Periodic Reporting Regime.

AMG further recommends that the periodic reporting requirement be revised to mirror the reporting frequency under Rule 38a-1 of the 1940 Act.[28] For example, upon adoption of the Proposed Rule, the board could conduct an initial comprehensive review of the adviser's fair value policies and procedures, including methodologies used and detailed conflicts of interest

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[26] *See* Proposing Release at 46-47.

[27] *See* Proposing Release at 45.

[28] *See* 17 CFR § 270.38a-1(a)(3).

reports, prior to adoption and implementation of these policies and procedures by the adviser. The board would then receive an annual written report assessing the adequacy and effectiveness of the adviser's process for determining the fair value of portfolio investments. The board would also receive a quarterly report detailing material changes to the adviser's fair value policies and procedures, or significant issues affecting the fair value process, but which omits many of the topics detailed above where there are no significant items to report.[29] This would permit a board to rely on its business judgment to determine the content and timing of the periodic reporting, while still ensuring that the board performs regular, meaningful oversight of fund valuation functions.

In the alternative, AMG recommends that the periodic reporting requirement be revised to permit funds to provide a comprehensive deep dive report to the board on an annual basis provided they report to the board on significant matters impacting valuation throughout the year. Reviewing an annual written report that addresses the operation of the fund's valuation functions and assesses its adequacy and effectiveness would enable the board to assess the implementation of these functions. AMG believes that moving from a quarterly reporting scheme to an annual reporting scheme would promote a more in-depth discussion between boards and advisers. As the Commission has acknowledged, boards "want clarity from regulators regarding their responsibilities…but not at the cost of effectiveness."[30] AMG believes that, unless revised, the periodic reporting requirement in the Proposed Rule could diminish the effectiveness for boards and advisers.

Prompt Reporting Requirement.

AMG agrees that it is important for the adviser to notify the board on an ad hoc basis when unexpected and urgent fair valuation matters arise.[31] Under the Proposed Rule, the adviser would be required to promptly, but in no event later than three business days after the adviser becomes aware of the matter, provide a written report to the board on matters "associated with the adviser's [fair value] process that materially affect or could have materially affected the fair value" of portfolio investments, including "a significant deficiency or material weakness in the design or implementation of the adviser's fair value determination process or material changes in the fund's valuation risks."[32] AMG appreciates that the prompt reporting requirement is intended to bring a wide variety of important and context-specific topics to the board's prompt attention. We note that many of our members already follow a similar practice under their existing fair value policies and procedures. However, for the following reasons, we believe that the prompt reporting requirement should be removed from the Proposed Rule.

First, AMG believes that three business days may not be a sufficient period of time to identify and determine a material effect on the fair value of investments and also prepare a written report as contemplated by the prompt reporting requirement. AMG appreciates and agrees with the Commission's view in the Proposing Release that the adviser may need to take additional time to evaluate and consider how best to address a matter affecting the fair value process before

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[29] *See* 17 CFR § 270.38a-1(a)(4)(iii). Additionally, the board may receive prompt reporting on material matters as determined by the board and the adviser, in consultation with the chief compliance officer and counsel.

[30] *See* Proposing Release at 46-47.

[31] *See* Proposing Release at 49.

[32] *See* Proposed Rule 2a-5(b)(1)(ii).

engaging the board.[33] AMG therefore requests that the Commission rely on the adviser's discretion, in consultation with the board, to determine what frequency of reporting and related substance, based on the facts and circumstances, enables effective oversight. This is especially true during periods of significant market stress, when resources could be more effectively deployed towards arriving at appropriate valuations and making ad hoc determinations as to necessary board and other communications. Based on an informal poll of AMG members, advisers maintain regular lines of communication with boards during adverse market conditions, including, most recently, during the significant downturn in March 2020 in response to the global pandemic caused by COVID-19.

Second, AMG believes that the "could have materially affected" prong of the prompt reporting requirement is ripe for second guessing. AMG submits that virtually any matter which on its own may not be material could theoretically become material in the context of a large scale investment or long or unexpected span of time. To illustrate, in the last few months, due to the global pandemic caused by COVID-19, various matters that, in isolation, were unlikely to have materially affected the fair value of portfolio investments turned out to have an impact on the fair value of portfolio investments. Even now, with a rapidly changing market environment and ongoing social upheaval, it is possible that, hindsight being 20/20, many matters "could have materially affected" the fair value of portfolio investments. AMG believes that the inclusion of such a speculative and open-ended element in the prompt reporting requirement may invite second-guessing of boards' business judgment regarding the materiality of any event on the adviser's fair value process and resultant fair value determinations.

Finally, AMG believes that any prompt report, as determined necessary by the adviser, in consultation with the board, need not be in writing, at least as an initial matter, and may be satisfied by notification to a designated trustee, as opposed to the full board. We submit that any material issues may be subsequently memorialized in a periodic report to the board. AMG believes that, at minimum, if not removed in its entirety from the Proposed Rule, the prompt reporting requirement should be revised to account for these revisions.

If the Commission retains the prompt reporting requirement, AMG seeks clarification on certain elements of this requirement. First, to what extent do advisers (or boards and advisers, working together) retain discretion to determine what constitutes a "material" affect on the fair value process? In the Proposing Release, the Commission asks whether this materiality threshold should be replaced with specific triggers, such as a specific number of overrides.[34] The Commission has previously noted that "material," in the context of Rule 38a-1, is a change that a board member would reasonably need to know in order to oversee fund compliance and that "serious compliance issues" must be raised with the board immediately.[35] It is likely that the industry will use these clues to guide its approach on what constitutes a "material" valuation matter under the Proposed Rule.[36] In AMG's view, both the lack of direction and the breadth of

[33] *See* Proposing Release at 50-51.

[34] *See* Proposing Release at 50-51.

[35] *See* Proposing Release at n. 68.

[36] AMG presumes that the historically appropriate assessments for net asset value and fair valuation errors will remain intact under the Proposed Rule. Accordingly, AMG expects that boards and advisers will borrow from concepts of

the prompt reporting requirements will make compliance imprecise and the overall process ripe for second guessing, especially with respect to topics such as what is a "matter associated with the adviser's process"?

Flexible Reporting Based on the Type of Fair Value Inputs Used.

AMG also recommends that the Commission use a three-tier approach to better assess valuation risks and conflicts of interest and to reconsider related periodic reporting and recordkeeping requirements.[37] To illustrate, the three-tier approach would classify potential conflicts and the corresponding level of required reporting as follows:

> (i) tier 1 would relate to investments for which market quotations are readily available;
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> (ii) tier 2 would relate to investments for which valuations are sourced from independent pricing vendors; and
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> (iii) tier 3 would relate to investments for which there are no or limited observable inputs and reliance on the adviser is essential.

Once framed this way, it is easier to appreciate the difference between the risks and conflicts of interest presented by a fair valuation process that relies on valuations from independent pricing vendors (tier 2) and a fair valuation process that relies heavily on adviser-provided input (tier 3). The risks and conflicts presented at tier 2 relate to the use of pricing vendors by the funds and may be managed with appropriate due diligence, testing and oversight controls. In contrast, for tier 3, the focus is on conflicts related to the adviser's direct involvement in fair value determinations, which calls for additional scrutiny when compared to tier 1 and tier 2 investments. As noted by the Commission in the Proposing Release, with respect to level 3 investments under ASC Topic 820, boards evaluating tier 3 prices should consider whether the fund's adviser may have an incentive to improperly value fund assets so as to increase fund fees, improve or smooth reported fund returns, or comply with the fund's investment policies and restrictions.[38]

If the Commission determines to adopt the periodic reporting requirements in the Proposed Rule without making any of the suggested changes discussed above, AMG recommends that the Commission maintain the periodic reporting requirement with respect to the assessment and management of material valuation risks for tier 3 investments only. For tier 2 investments, the Commission could address the risks presented by pricing services through oversight controls instead of periodic reporting. For example, in the adopting release for money market fund reform, the Commission provides the following guidance to funds and their boards regarding reliance on pricing services:

> "Before deciding to use evaluated prices from a pricing service to assist…in determining the fair values of a fund's portfolio securities, the fund's board of directors may want to consider the inputs, methods, models, and assumptions used by the pricing service to

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materiality in the context of pricing errors, such that a prompt reporting requirement would be triggered if, for example, there is an impact of more than fifty basis points to a fund's net asset value.

[37] While the proposed three-tier approach is similar to the approach taken in ASC Topic 820 (i.e., Level 1, 2 and 3) to fair value accounting, the emphasis is slightly different, especially with respect to tier 2.

[38] *See* Proposing Release at 36.

> determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change. In choosing a particular pricing service, a fund's board may want to assess, among other things, the quality of the evaluated prices provided by the service and the extent to which the service determines its evaluated prices as close as possible to the time as of which the fund calculates its net asset value. In addition, the fund's board should generally consider the appropriateness of using evaluated prices provided by pricing services as the fair values of the fund's portfolio securities where, for example, the fund's board of directors does not have a good faith basis for believing that the pricing service's pricing methodologies produce evaluated prices that reflect what the fund could reasonably expect to obtain for the securities in a current sale under current market conditions."[39]

Boards and advisers could use this guidance to assess pricing services when such services are on-boarded and then annually thereafter (instead of on a quarterly basis).

Similarly, AMG recommends that the Commission apply this three-tier approach to recordkeeping requirements. The Proposed Rule would require maintenance of appropriate documentation to support all 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. This level of detail may make sense for tier 3 investments, but not necessarily for tier 2 investments, assuming boards and advisers have appropriate oversight controls for pricing vendors. AMG believes that there is little value in requiring advisers to obtain detailed information regarding methodologies and inputs used by approved third party pricing vendors in supplying valuations to a fund.

In sum, AMG believes that the proposed reporting requirements are likely to generate an unmanageable and unhelpful volume of information for board review that may dilute the impact of any significant report on a material issue. AMG is concerned that the Proposed Rule's requirement with respect to the periodic assessment of any material risks associated with the determination of fair value will not result in tangible improvements to fair valuation practices. Instead, this requirement may result in additional spreadsheets and risk assessments for pricing teams to prepare and a board inundated with volumes of information that leaves the board susceptible to second guessing in the event valuation errors are detected down the road. AMG also encourages the Commission to acknowledge the difference in the types of risks and conflicts presented by tier 2 and tier 3 investments and ease the requirements under the Proposed Rule relating to the assessment of valuation risks and conflicts of interest, periodic reporting, and recordkeeping for tier 2 investments. AMG welcomes the opportunity to further discuss these recommendations with the Commission.

Price Challenges under the Proposed Rule

The Proposed Rule would provide that determining fair value in good faith requires the oversight and evaluation of pricing services. Accordingly, funds that use pricing services would be required to establish (a) a process for the approval, monitoring, and evaluation of each pricing

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[39] See Money Market Fund Reform; Amendments to Form PF, SEC Release No. 33-9616 (July 23, 2014), available at https://www.sec.gov/rules/final/2014/33-9616.pdf. Note, however, that this guidance would be rescinded under the Proposal.

service provider, and (b) criteria for initiating price challenges. An example of a price challenge involves the fund's disagreement with an evaluated price provided by a pricing service.[40] AMG is concerned that the establishment of defined "criteria," such as the introduction of objective thresholds, to determine when price challenges should (or not) be initiated may lead a fund to adopt a less informed and more mechanical price challenge process.

Based on an informal survey of AMG members, a strong majority of advisers already have price challenge processes in place. To illustrate, the adviser's investment staff and traders (the "**challenging staff**") will review vendor prices daily and may challenge any price that is viewed as inaccurate, regardless of the size or materiality of the perceived price inaccuracy. The challenging staff is required to provide supporting documentation for the perceived inaccuracy, but is otherwise removed from the rest of the challenge process. The challenge is then discussed and reviewed with the pricing service and the adviser's operations and valuation staff and, if necessary, the adviser's valuation committee.

AMG believes that this process places discretion for price challenges in the hands of market experts. Introducing stipulated thresholds or similar criteria could lead to mechanical or routine price challenges or could compel the challenging staff to raise a price challenge simply to avoid second guessing by auditors, the board, or the Commission. Further, AMG disagrees with the Commission that "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."[41] We believe this issue can be managed without the introduction of specific criteria, and, as noted above, the existence of a price challenge mechanism suggests a well-functioning valuation process. Price challenges are part of the regular cadence of communications with pricing services. The Proposing Release implies that a challenge is an adverse event that brings into question the quality of the vendor. We note that, in practice, vendors are hungry for any and all data and having more data is typically viewed as a good thing. Further, the vendors often have information the adviser does not have. Therefore, AMG believes that pricing challenges may be viewed as a critical component of an iterative process between the vendor and its customers. Similarly, we view the proposal to report all price overrides to the board as an indicator of a need to question the quality of the pricing vendor as misguided, and we would prefer to report instead on trends of override volumes and/or report large outliers since that information will be more meaningful.

AMG therefore encourages the Commission to keep the requirement to adopt a price challenge process, but leave the details of how that process is established and implemented, including any criteria, thresholds, or other considerations, to the purview of the board and the adviser. The Commission can then manage the process by setting basic parameters through board reporting requirements, conflicts of interest monitoring, and recordkeeping requirements. In this way, the Commission can still achieve its goal of oversight and evaluation of pricing services without inadvertently undermining the flexibility necessary to initiate price challenges, as determined necessary by challenging staff.

Committee Comments on the Impact of Recent Adverse Market Conditions.

[40] *See* Proposing Release at n. 63.

[41] *See* Proposing Release at n. 113.

AMG notes that Commissioner Peirce queried whether the Proposed Rule would have "helped, hurt, or had little impact on board valuation efforts had it been on the books during the monumental valuation challenges" presented by recent adverse market conditions caused by COVID-19, and whether the Proposed Rule should account for any learning from such recent market activity.[42] As noted previously, the Proposed Rule is more prescriptive with respect to periodic and prompt reporting requirements and, unsurprisingly, during times of market volatility, compliance with such prescriptive requirements may cause more harm than good. Specifically, the Proposed Rule's prompt reporting requirements could distract the adviser from managing the fund's valuation risk in times of significant market stress by causing them to divert limited resources away from evaluating the prices of fund investments. A global event such as COVID-19 has been and will continue to be, for the foreseeable future, a prominent issue for discussion with fund boards, such that many, if not all, advisers in the last few months have been in frequent communication with boards about the issues presented by current adverse market conditions. AMG suggests that the Proposed Rule's requirements with respect to prompt reporting be revised to allow boards and advisers to determine the appropriate timeframe for furnishing reports during times of significant market stress.

The Commission may further consider granting boards and advisers additional flexibility during times of significant market stress to make certain adjustments when pricing vendors provide the fund with information that is lagging or otherwise stale. For example, the Proposed Rule may contemplate the use of a methodology not previously approved by the board so long as the new methodology is ratified at the next regularly scheduled meeting of the board. We note that these changes would be consistent with boards exercising judgment in overseeing the valuation experts to whom they have assigned responsibility for fair valuation determinations.

Committee Comments on Importing U.S. GAAP into a Rule under the 1940 Act.

AMG generally supports formally defining the term "readily available." Currently, the term "readily available" is not defined under the 1940 Act and related rules and regulations, such that, currently, many in the industry rely on ASC Topic 820 and its definitions. The Proposed Rule would fill the gap by providing that, for purposes of Section 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.[43] The Commission elaborates on this definition, as follows: "[A] quote would be considered unreliable under [the Proposed Rule] in the same circumstances where it would require adjustment under U.S. GAAP or where U.S. GAAP would require consideration of additional inputs in determining the value of the security."[44] However, AMG is concerned that the Proposal imports U.S. GAAP standards into rules under the 1940

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[42] *See* Peirce, Hester M., "Statement on Good Faith Determinations of Fair Value under the Investment Company Act of 1940 Proposal," SEC (April 21, 2020), available at https://www.sec.gov/news/public-statement/statement-peirce-fair-value-2020-04-21. COVID-19, the novel respiratory disease also known as "coronavirus," has been declared a global pandemic, resulting in closed borders, enhanced health screenings, healthcare service shortages, quarantines, cancellations, disruptions to supply chains and vendor and customer activity, as well as general concern and uncertainty across global markets.

[43] *See* Proposed Rule 2a-5(c). We note that this is an odd construction – a price that is readily available could be either reliable or unreliable. Defining a price as available only if available and reliable seems unnecessarily complex.

[44] *See* Proposing Release at 58.

Act. U.S. GAAP standards could change without notice to, or review of the effect of such changes by, the Commission. In fact, the Commission acknowledges this point in the Proposing Release, stating that "specific references and principles in U.S. GAAP may change over time."[45] Accordingly, AMG recommends that the Commission consider providing interpretative guidance on the term "readily available," rather than formally linking, perhaps with unintended consequences, one 1940 Act term to potentially changing U.S. GAAP principles.

Committee Comments on Rescission of Existing Guidance on Fair Valuation.

In the Proposing Release, the Commission suggests rescinding ASR 113, ASR 118, and certain Commission staff letters and other guidance addressing a board's determination of fair value and other matters covered by the Proposed Rule. While AMG acknowledges that industry participants are no longer relying on ASR 113 and ASR 118 for valuation guidance and that these releases conflict with U.S. GAAP, it also cautions against the recommended rescission of Commission staff letters and other guidance identified in the Proposal unless the Commission has carefully reviewed each item of guidance for its continued utility. For example, the Proposed Rule would require consistent application of fair value methodologies, and in particular that "any methodologies selected be applied consistently to the asset classes for which they are relevant."[46] This seems overly prescriptive and contradicts previous guidance from the Commission that permits a board to adopt differing fair value policies for the same security held by different funds (e.g., a mutual fund vs. an ETF) overseen by that board if appropriate given the context and nature of the fund.[47] However, this guidance would be withdrawn pursuant to the Proposal. Accordingly, AMG requests that the Proposed Rule explicitly retain language that would afford a board, or its adviser, the flexibility to adopt differing fair value policies for the same security across fund complexes in appropriate circumstances.

Other Topics Included in the Proposal.

AMG highlights several other topics in the Proposal for further consideration by the Commission.

Role of Sub-Advisers.

Under the Proposed Rule, a fund's board could assign fair value determinations relating to any or all fund investments to a fund's primary adviser or one or more sub-advisers. In the Proposing Release, the Commission explains that a "multi-manager fund could have multiple advisers assigned the role of determining fair value of the different investments that those advisers manage" and that the fund's policies and procedures should address the "added complexities of overseeing multiple assigned advisers in order to be reasonably designed to avoid violating the

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[45] *See* Proposing Release at n. 128.

[46] *See* Proposing Release at n. 46.

[47] *See* Division of Investment Management Letter to the Securities and Exchange Commission, Office of Chief Counsel, Fed. Sec. L. Rep. [1993-2001 Transfer Binders] ¶77, 658 (Dec. 8, 1999), available at https://www.sec.gov/divisions/investment/noaction/1999/ici120899.pdf; *see also* Division of Investment Management Letter to the ICI Regarding Valuation Issues, Fed. Sec. L. Rep. [2001 Transfer Binder] ¶78, 113 (April 30, 2001), available at https://www.sec.gov/divisions/investment/guidance/tyle043001.htm ("the good faith requirement is a flexible concept that can accommodate many different considerations, and that the specific actions that a board must take will vary, depending on the nature of the particular fund, the context in which the board must fair value price, and the pricing procedures adopted by the board.").

federal securities laws."[48] The Proposal acknowledges that reconciling differing opinions on the same investment and establishing clear reporting structures will be challenging, but does not provide any guidance for multi-manager funds. It is likely that certain boards that have appointed advisers that are not primarily asset managers, such as insurance companies, will seek to take advantage of the Proposed Rule and assign fair value determination duties to sub-advisers that did not previously contemplate handling this additional responsibility and do not currently possess the means to do so effectively.

As a threshold matter, there is a question as to whether fair valuation is an appropriate role for a sub-adviser to fill. Sub-advisers that do not currently assume fair value responsibilities may seek to amend investment advisory agreements, revisit compensation terms, or establish or amend related policies and procedures to enable them to make such adequate and effective fair value determinations as contemplated under the Proposed Rule. Certain sub-advisers may be forced to consider expanding or adding additional resources necessary for the sub-adviser to assume this new function. On a more technical note, if a sub-adviser assumes reporting responsibilities under the Proposed Rule, presumably the sub-adviser would need to be in attendance at most board meetings to discuss fair value issues, as well as for regular due diligence purposes. If an adviser serves as sub-adviser to various funds and the boards of those funds have their own preferences on the presentation of periodic and prompt reporting, this could lead to an unmanageable set of bespoke arrangements for any given sub-adviser. For example, where the adviser makes its own price challenges, it may not be in a position to break out and report the price challenges that are relevant to each fund for which it serves as sub-adviser.

Given the acknowledged variables, AMG recommends that the Commission recognize that any proposed assignment of fair value determinations to a fund's sub-adviser would depend on the facts and circumstances of the particular adviser and sub-adviser relationship with the fund and its board. Similarly, AMG recommends that the Commission clarify that any necessary reconciliation in the event there are differing opinions among sub-advisers on the same investment, as well as who would determine what fair value methodology to use, would depend on the facts and circumstances of the particular adviser and sub-adviser relationship with the fund and its board.

Fair Value Methodologies.

The Proposed Rule would provide that fair value as determined in good faith requires selecting and applying appropriate valuation methodologies in a consistent manner. AMG agrees with the Commission that "different methodologies may be appropriate for different asset classes" and that this requirement should 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."[49] AMG also agrees with the Commission that the Proposed Rule's requirement to apply fair value methodologies in a consistent manner should not preclude the board or the adviser from changing a methodology for a particular investment where an adjustment to such methodology would be appropriate based on the facts and circumstances.[50] AMG finds, however, that this flexibility is only mentioned in the Proposing Release and not in

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[48] *See* Proposing Release at 33-34.

[49] *See* Proposing Release at n. 46.

[50] *See* Proposing Release at 21.

the Proposed Rule. AMG believes it is important to codify this flexibility in the Proposed Rule and recommends that the Commission add a "catch-all" provision that captures the ability to choose a different methodology than the selected methodology if the facts and circumstances warrant the adjustment and the board or the adviser believe that such adjustment would result in a measurement that is equally or more representative of fair value.

The Proposed Rule's requirement to select and apply appropriate valuation methodologies in a consistent manner also would include specifying the key inputs and assumptions specific to each asset class or portfolio holding, and the methodologies that would apply to new types of investments in which the fund intends to invest. In this regard, AMG seeks clarification as to how identifying key inputs and assumptions regarding specific asset types would add value to the fair valuation process. AMG is concerned that the identification process could be very time consuming as there may be considerable variability in the inputs and assumptions even for instruments within the same asset class, and it is not clear that the benefits of this identification exercise are commensurate with the potential costs.

Finally, the Proposal would require that a fund devise methodologies for anything a fund does not currently hold but which it intends to invest in the future. While we understand the underlying rationale, we believe that this will be difficult to implement in practice. We question how a fund will determine whether it might "intend" to invest in an instrument in the future. As an example, fixed income investments come in all sizes and shapes with features that are negotiable in many cases. Different funds will interpret these terms differently, and, under the Proposed Rule, funds would need to devise methodologies for these "just in case" scenarios. In the absence of clear guidance regarding whether a methodology has been approved already, funds may be left out of trade allocations if they are unsure about whether the fund has adopted an appropriate pricing methodology in advance. Further, it is unclear whether this requirement under the Proposed Rule makes sense for true fair value instruments that require bespoke valuation methodologies. AMG recommends that this requirement be removed from the Proposed Rule.

Striking the Right Balance on Assignment.

In her statement on the Proposal, Commissioner Peirce asks whether the Proposed Rule will "assist fund boards in efficiently and effectively meeting their valuation obligations and thus protect the fund and its investors[.]"[51] AMG observes that, in assigning fair value determinations to the adviser, the board does not dispense with its duties to determine fair valuations in good faith, and yet assignment introduces numerous prescriptive requirements regarding the frequency and nature of an adviser's reports to the board. Commissioner Peirce also acknowledged this concern, stating that the Proposed Rule's benefits "may be diminished significantly by an overly prescriptive approach to ensuring adequate board administration of the fair valuation process.[52] To that end, if a board chooses not to assign fair value determinations to the fund's adviser, AMG seeks clarification as to the board's ability to engage third parties to assist in the fair valuation process. For example, AMG would support the introduction of certain parameters around the engagement of a pricing vendor or the fund's custodian as a consultant to the board. In any case, AMG believes that it is unlikely for boards to assign fair value determinations to an

[51] *See* Peirce, Hester M., supra n. 37.

[52] *Id*.

adviser with respect to only some investments but then determine fair value of other investments themselves given the additional prescriptive reporting obligations under the Proposed Rule when a board chooses to assign fair value determinations to the adviser.

Back-testing.

The Proposed Rule would require testing of the appropriateness and accuracy of the methodologies used to calculate fair value.[53] In the Proposing Release, the Commission states that "calibration and back-testing can be particularly useful in identifying trends, and also have the potential to assist in identifying issues with methodologies applied by fund service providers, including poor performance or potential conflicts of interest."[54] The Commission does not, however, discuss or define "back-testing" as a concept, which may present difficulties for complexes that conduct a large number of diverse fair valuations. We note that the very nature of true fair value determinations make them difficult to calibrate or back test. Adjusting based on changes in circumstances may be possible, but back testing and calibration of fair value determinations is often not possible until there is a trade execution or other market event. Therefore, AMG seeks additional color from the Commission on what calibration and testing practices would satisfy the back-testing requirement under the Proposed Rule.

In addition, we note that the requirements around back testing, calibration, transparency and evaluation of inputs may require advisers to develop additional data science capabilities to analyze valuation data and perform necessary testing. Doing additional work on level 3 instruments makes sense, but deeply analyzing level 2 instruments would represent a major change from current practices. It is unclear how much added value there would be to adding layers of diligence and quality control around these data functions, but we expect it will add to expenses at the adviser, sub-adviser and pricing vendor levels, which are likely to be borne by fund investors.[55]

Assignment and Compensation.

While AMG strongly supports the Proposed Rule's express permission to assign fair value determinations to the fund's adviser and recognizes that this is a welcomed step for many fund boards, there may be a notable increase in expenses associated with the formal assignment of such duties. For example, depending on the terms of the investment advisory agreement and how valuation fits within the defined services performed by the adviser thereunder, a fund's adviser could, as the Commission notes, demand higher fees as compensation for increased valuation responsibilities, including increased compliance and reporting duties.[56] If so, AMG agrees with

[53] Proposed Rule 2a-5(a)(3).

[54] *See* Proposing Release at 23.

[55] It also is not clear how often funds would be able to continue to use broker quotations. While they are often the least preferred option, sometimes they are the best available option. However, if the requirements to be able to use broker quotes are too high, then they not be viable options.

[56] *See* Proposing Release at 101. AMG notes that increasing contractual advisory fees is very difficult and costly given the shareholder approval requirement. Therefore, we suggest that the Commission make it clear that, where appropriate, the adviser be permitted to pass along its costs in performing its assigned valuation duties outside of the advisory contract. Regardless of the approach used, AMG expects that the adviser's performance of additional valuation duties, and any compensation therefor, will be considered as part of the annual Section 15(c) advisory contract renewal process. *See also* the Proposing Release at 37, suggesting that compliance needs to take on additional responsibilities to support the fund's fair value processes ("In addition, boards should consider the adviser's

the Commission that any higher fees requested by the adviser could be passed on to fund shareholders in the form of higher fund fees.[57]

C. Conclusion

AMG believes that the Proposal and the Proposed Rule reflect the careful, thoughtful consideration of the Commission and the Division of Investment Management staff, and also acknowledge the role of advisers in the fair value determination process given the increased complexity of fund portfolios. Nevertheless, AMG believes that the Commission should make certain changes to the Proposal to ensure that fund valuations are conducted appropriately and consistent with the requirements of the 1940 Act, while still permitting boards to exercise their business judgment in overseeing the work of the advisers to whom they assign fair valuation. AMG is looking forward to discussing these comments with the Commission and the Division of Investment Management staff.

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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.").

[57] *Id*.

SIFMA AMG sincerely appreciates the opportunity to comment and your consideration of these views. We stand ready to provide any additional information or assistance that the Commission might find useful. Please do not hesitate to contact either Timothy Cameron at 202-962-7447 (tcameron@sifma.org) or Lindsey Keljo at 202-962-7312 (lkeljo@sifma.org), or our outside counsel, Edward Baer, Ropes & Gray LLP, at 415-315-6328 (edward.baer@ropesgray.com) or Jimena Smith, Ropes & Gray LLP, at 415-315-2306 (jimena.smith@ropesgray.com), with any questions.

Sincerely,

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cc: Honorable Jay Clayton, Chairman, U.S. Securities and Exchange Commission

Honorable Hester M. Peirce, Commissioner, U.S. Securities and Exchange Commission

Honorable Allison H. Lee, Commissioner, U.S. Securities and Exchange Commission

Honorable Elad L. Roisman, Commissioner, U.S. Securities and Exchange Commission

Ms. Dalia Blass, Director, Division of Investment Management, U.S. Securities and Exchange Commission