



July 21, 2020

Mrs. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

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

Dear Secretary Countryman:

Better Markets¹ appreciates the opportunity to comment² on the above-captioned proposal (“Release,” “Proposal,” or “Rule”) published for public comment by the Securities and Exchange Commission (“SEC” or “Commission”). In the Release,³ the Commission is proposing a new SEC Rule 2a-5 to modernize and standardize how boards of directors of investment companies determine in good faith the fair value of assets for which market prices are not readily available. The Rule also would authorize investment company’s board to assign—subject to certain conditions—the good faith determination of fair value to outside investment advisers. The Rule largely codifies but also standardizes industry and regulatory practices that has developed over the previous four decades. We support the Proposal. However, we recommend that in the final rule the Commission adopt the two changes we offer below.

COMMENTS

Investment companies pool together trillions of dollars’ worth of savings and invest in various types of assets. Much of these assets, such as municipal bonds and private placements, do not have readily available market prices because, for example, they seldom trade. In these instances, investment companies’ boards of directors are required to conduct good faith determinations of the fair values of these assets, as the value of these assets is factored in the calculations of the Net Asset Value (NAV) of the fund. The NAV is in turn used to set the price

¹ Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans’ jobs, savings, retirements, and more.

² Given the importance of the topics, the relatively short comment period afforded, and the national emergency due to the COVID-19, we reserve the right to supplement this comment letter with additions to either offer further commentary on separate aspects of the Proposal or to rebut and respond to other commenters.

³ See Good Faith Determinations of Fair Value (Release No. IC-33845; File No. S7-07-20) 85 Fed. Reg. 28734 (May 13, 2020) available at <https://www.federalregister.gov/documents/2020/05/13/2020-08854/good-faith-determinations-of-fair-value>.

at which the shares of the funds are offered or redeemed (repurchased). Therefore, for investors to confidently make informed investment decisions in purchasing or redeeming shares of these funds, the NAV must reflect the fair value of the underlying assets, and the valuation process must be unbiased and accurate. Fair valuation of assets also impacts the funds' "asset-based and performance-based fee calculations; disclosures of fund fees, performance, NAV, and portfolio holdings; and compliance with investment policies and limitations."⁴ The risks of "improper valuation can cause investors to pay fees that are too high or to base their investment decisions on inaccurate information."⁵

The proposed Rule specifies how a board of directors of an investment company must make good faith determinations of fair value of assets for which there are no readily available market prices. The new Rule would also explicitly permit the boards of investment companies to assign these functions of good faith determinations of fair value to registered investment advisers. Importantly, the Rule would maintain statutory and fiduciary requirements that boards of investment companies owe to shareholders of these funds and investment advisers' fiduciary duty to the investment company.

The Rule would apply to all registered investment companies and Business Development Companies, regardless of their classification or sub-classification (e.g., open-end funds and closed-end funds), or their investment objectives or strategies (e.g., equity or fixed income; actively managed or tracking an index).⁶ These investment funds collectively manage over \$30 trillion⁷ of savings, endowments, retirement funds, state and local governments treasuries, etc. Finally, as of December 2018, "there were 57.2 million U.S. households and 101.6 million individuals owning U.S. registered investment companies that could be affected" by the proposed Rule.⁸

The Rule would set requirements for determining fair value in good faith for purposes of section 2(a)(41) of the Investment Company Act. This determination would involve assessing and managing material risks (including conflicts of interests) associated with fair value determinations; selecting, applying, and testing fair value methodologies (including back-testing and calibration); evaluating any pricing services used; adopting and implementing policies and procedures; and maintaining certain records for up to five years to aid compliance with the Rule.

The second prong of the Rule would permit an investment company's board of directors to assign these requirements (*i.e.*, fair value determinations; managing material risks; creating and applying methodologies, including testing; record keeping, etc.) to an investment adviser to the fund for some or all of the fund's investments.⁹ Once an investment adviser is assigned these functions, the fund's board would be required to conduct engaged and proactive oversight of the investment adviser. The investment adviser would be required to produce detailed and prompt reports describing how the investment advisers complies with the requirements of the new Rule 2a-5.

⁴ See Release at 28735.

⁵ See Release at 28735.

⁶ See Release at 28738.

⁷ See Release at 28754.

⁸ See Release at 28756.

⁹ See Release at 28766.

The third provision of the Proposal would define when market quotations are readily available under section 2(a)(41) of the Act, and therefore clearly delineate when a fund's board must conduct good faith determination of fair value (or assign such functions to an investment adviser). And finally, the proposal would rescind several Commission statements, exemptive letters, guidances issued over the previous four decades as these would now be supplanted by the new Rule 2a-5.

With the exception of the approach the Commission is proposing to managing conflicts of interest at investment adviser firm, we support all other aspects of the Proposal, and we urge the Commission to approve the new Rule 2a-5 as modified with the two suggestions offered below.

Commission Should Mandate That Investment Companies' Boards Have Expertise Necessary To Appropriately Evaluate The Performance of Investment Advisers' Good Faith Determination of Fair Value.

The Commission appropriately requires that those investment companies that choose to assign the good faith determination of fair value to investment advisers must also engage in robust oversight of these advisers. But nothing in the Proposal would require that boards of investment companies have independent members who have the requisite experience to be able to effectively assess the performance of the investment advisers' good faith determination of fair value. We urge the Commission to require that boards of investment companies to have members who would have the necessary experience, knowledge, and be sufficiently conflict-free to appropriately and effectively fulfill their fiduciary and statutory obligations (and the requirements of the proposed Rule) in overseeing the work of the investment advisers.

The Proposal would require the adviser to submit detailed and prompts reports to the board with respect to matters related to the adviser's fair value process, in part to ensure that the board has sufficient information to conduct this oversight."¹⁰ But nothing in the Proposal gives as confidence that those boards of investment companies that find themselves unable to conduct good faith determinations of the fair value of complex and illiquid assets would in fact be in a position to digest, analyze, and make informed decisions (in compliance with their fiduciary duties and the requirements of the Investment Company Act) based on the reports that investment advisers provide. We agree with the Commission that these investment companies' boards "should approach their oversight of fair value determinations assigned to an investment adviser of the fund with a skeptical and objective view that takes account of the fund's particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determination process, and the skill and resources devoted to it."¹¹ We further agree with the Commission that such "effective oversight cannot be a passive activity..." and that "directors should ask questions and seek relevant information." And finally, that "the board should view oversight as an iterative process and seek to identify potential issues and opportunities to improve the fund's fair value processes."¹²

¹⁰ See Release at 28743.

¹¹ See Release at 28743.

¹² See Release at 28743.

For all these reasonings and requirements that are “designed to help ensure that boards obtain the information [particularly with regard to an adviser’s reporting on its own conflicts of interest] that they need to exercise their statutory and fiduciary duties and to oversee an adviser” and the Rule’s subsequent and clear warning that the requirements are “intended to supplement, not replace, [investment companies’ boards] oversight”¹³ we believe the investment companies’ boards must have members who would be able to meet all of their statutory requirements and conduct effective oversight of investment advisers in the interest of investors.

Commission Should Prohibit Portfolio Managers From Engaging In Fair Value Determinations.

The Rule, as proposed, would invite and entrench the obvious conflicts of interest that investment advisers and portfolio managers that participate in determining the fair value of assets have. As is known the Commission, investment advisers have:

“incentives to inflate fund asset values (or deflate fund liability values) because they typically receive a management fee that is calculated as a percentage of the value of assets under management. Relatedly, investment advisers have incentives to inflate fund asset values because investors tend to invest more in funds that performed well in recent periods, which would increase assets under management and ultimately increase investment advisers’ compensation. Investment advisers also have incentives to mis-measure fund investments in a way that would result in smooth reported fund performance over time to lower the funds’ perceived risk. Finally, investment advisers may mis-measure fund investments as a result of expending less effort to value assets than the effort required to ensure accurate and unbiased valuations.”¹⁴

While the Rule would require investment advisers to “reasonably segregate the process of making fair value determinations from the portfolio management of the fund,”¹⁵ the Rule would explicitly permit portfolio managers to “provid[e] inputs that are used in the fair value determination process.”¹⁶ In fact, the Proposal explicitly declines to establish a “firewall” between portfolio managers and investment advisers or to “require strict protocols regarding communications between specific personnel” so that, in the view of the Commission, “funds [could] structure their fair value determination process and portfolio management functions in ways that are tailored to each fund’s facts and circumstances, including the size and resources of the fund’s adviser.”¹⁷

We strongly disagree with this approach. Portfolio managers suffer un-manageable conflicts of interest as their compensation is based on the returns of the fund. If assets are valued in unbiased and accurate manner, these fund returns may suffer, and the portfolio manager’s

¹³ See Release at 28745.

¹⁴ See Release at 28756.

¹⁵ See Release at 28747.

¹⁶ See Release at 28747.

¹⁷ See Release at 28747-48.

compensation may consequently suffer. Therefore, given these un-manageable conflicts of interests, we urge the Commission to prohibit portfolio managers from participating in good faith determination of fair value at investment advisory firms.

CONCLUSION

We hope our comments are helpful to the Commission as it considers the approval of the Rule.

Sincerely,

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