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July 21, 2020

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Proposed Rule: Good Faith Determinations of Fair Value
SEC Release No. IC-33845; File No. S7-07-20

Dear Madam Secretary:

CFA Institute[1] is pleased to provide you with our perspectives on areas for consideration in conjunction with the Securities and Exchange Commission's (SEC's or Commission's) *Proposed Rule: Good Faith Determinations of Fair Value* ("Proposed Rule"). CFA Institute has long advocated for high quality standards regarding the determination of fair value and is pleased to offer its comments regarding the Proposed Rule.

We are providing comments consistent with our objective of promoting fair and transparent capital markets and advocating for investor protections. An integral part of our efforts toward meeting those goals is ensuring that corporate financial reporting and disclosures provided to investors and other end users are of high quality. Our advocacy position is informed by our respective members who invest, both domestically and globally, and in consultation with CFA Institute's Corporate Disclosure Policy Council ("CDPC").[2]

[1] CFA Institute is a global, not-for-profit professional association of nearly 171,400 investment analysts, advisers, portfolio managers, and other investment professionals in 165 countries, of whom more than164,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 154-member societies in 77 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors. CII's General Counsel is currently a member of the CDPC.

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OVERARCHING CONSIDERATIONS

Summarized below are our perspectives on several overarching considerations that we believe the Commission should bear in mind as it reviews the Proposed Rule.

Timely and Appropriate

As an overall matter, we believe it is timely and appropriate to update the SEC's guidance in this area. Proper valuation of a fund's investments is a critical component of investment decisions, and improper valuation can cause investors to pay fees that are too high or base their investment decisions on inaccurate information. In addition, since the SEC's guidance was last updated fifty years ago in 1970, new technologies have developed regarding pricing, third-party pricing services have proliferated, and significant regulatory developments, such as the introduction of the Sarbanes-Oxley Act, the Investment Company Act and the Advisers Act, and the FASB's issuance and codification of ASC Topic 820, *Fair Value Measurements* ("ASC 820") that established a framework for the recognition, measurement and disclosure of fair value under US GAAP, have all greatly altered the landscape for investment funds and their boards with respect to how they address valuation issues. Accordingly, we support the integration and modernization of this guidance.

Assume Boards Will Avail Themselves of Investment Adviser Latitude

For purposes of this discussion, we assume that a fund board will avail itself of the Proposed Rule's latitude in assigning the fair value function to the investment adviser to the maximum extent permitted by the Proposed Rule. We believe this will be the overwhelming position taken by fund boards if the Proposed Rule is adopted.

Process vs Accountability: The Oversight Process Should Not Obscure the Board's Fundamental Responsibility for Valuation

We support the goal of the SEC to provide a consistent, minimum framework for overseeing the fair value determination process by an investment adviser. In addition, we support the general outline of the proposed framework, which would require a fund board to:

- assess and manage material risks associated with the determination of the fair value of the fund's investments, including material conflicts of interest;
- select, apply, and test fair value methodologies, including establishing criteria for determining when market quotations are no longer reliable;
- oversee and evaluate pricing services;
- adopt and implement policies and procedures to achieve compliance with these requirements; and
- maintain certain records including documentation to support fair value determinations.

We believe the Proposed Rule sets forth a comprehensive governance structure that is sufficiently principles-based to allow boards the flexibility to adapt and tailor the framework to different circumstances, while at the same time providing a minimum standard for board responsibilities and oversight.

At the same time, we note that the previous guidance, as set forth in Accounting Series Release ("ASR") 113 and ASR 118, was a model of clarity and simplicity in articulating the role of the fund board in fair value determinations. While we are supportive of a robust framework that governs the process of overseeing an investment adviser, we are concerned that the Proposed Rule may be interpreted as overemphasizing these required processes at the risk of losing sight of the board's fundamental responsibility for "determining fair value in good faith". **We believe it is critical that the SEC emphasize as a foundational principle that the board may *delegate the process* of determining fair value but must always *retain its responsibility* for such determinations.** Accordingly, we recommend that the final rule begin with a clear statement similar to the principles articulated in ASR 118 that emphasizes that while a board may appoint persons to assist them in the determination of fair value, the board may not delegate to others the ultimate responsibility of determining the fair value of the assets of a fund. The framework that governs this process would then flow naturally from this foundational principle.

Board Members Should Possess "Valuation Literacy"

Because board members are ultimately responsible for determining fair value in good faith, we firmly believe that board members should possess sufficient skills to be able to do so. Valuation is one of the most critical matters that underlie the financial statements of an investment company, and it is a highly technical discipline. In the same way that the regulators mandated that audit committee board members be "financially literate," we believe **that it would be sound practice and good policy for the SEC to mandate "valuation literacy" for investment company board members**. While we appreciate that this Proposed Rule allows the board's role to be one of oversight and monitoring, the board must still be able to have the expertise to understand and assess the valuation functions performed by the investment manager. This means not only being able to understand the basic terminology and valuation process, but also being able to ask the "tough questions", evaluate the answers provided, and ask appropriate follow-up questions. In short, board members must be able to understand the valuation decisions that were made and why they were made. In our view, "general business savvy", or even the existing financial literacy requirements for audit committee members, is often not sufficient to fully understand the complexities of valuation issues. A valuation literacy requirement could consist of past employment experience in valuation, requisite professional certification, or any other comparable experience or background that indicates the individual's financial sophistication. We strongly encourage the SEC to consider undertaking an initiative on valuation literacy for fund board members, similar to the financial literacy initiative for audit committees, as we believe that such an initiative will further enhance the effectiveness of the board in carrying out its financial oversight responsibilities, thereby promoting the quality and reliability of an investment company's financial statements.

Corporate Governance Conflicts Must Be Robustly Addressed

As the Commission notes, because boards are permitted to delegate the process of making fair value determinations to a fund's investment adviser, whose compensation is often based on the fund's performance, potential conflicts of interest may arise, as the adviser may have incentives to improperly value fund assets in order to increase fees. **While the Proposed Rule addresses such conflicts with certain required measures, we believe that it does not go far enough in this regard, given how significantly these conflicts of interest could affect fund valuation.** Therefore, we believe the SEC should clarify that the board may not merely rely on the investment adviser's identification of such conflicts but has an affirmative duty to seek to discover conflicts of interest independently. In addition, we believe that the proposed measures for "reasonable segregation" of the fair value determination process from the actual management of the fund should also be strengthened, to further guard against these inherent conflicts of interest. In addition, we believe that the Proposed Rule should be extended to apply not just to fund advisers but also third parties such as pricing services and accounting firms, as we believe this would help boards manage potential conflicts of interest by bringing in independent advisers to provide an objective view on the valuations provided by the fund's investment adviser. Finally, we believe a board should be required to obtain written attestation from the adviser regarding its independence and freedom from conflicts of interest, so that both the adviser and the board are clear regarding the assertions made with respect to an adviser's objectivity.

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SPECIFIC CONSIDERATIONS

In addition to the overarching considerations above, we provide perspectives on key aspects of certain of the specific proposals below.

A. FAIR VALUE AS DETERMINED IN GOOD FAITH

1. Assessment of the Investment Adviser's Valuation Process, Including an Assessment of Valuation Risks, Should Be Performed Quarterly

The Proposed Rule would provide that determining fair value in good faith requires periodically assessing the adequacy and effectiveness of the investment adviser's process for determining the fair value of the assigned portfolio of investments, including:

- a summary of the assessment and management of material valuation risks and any material conflicts of interest;
- any material changes to, or material deviations from, the fair value methodologies established; the results of the testing of fair value methodologies;
- the adequacy of resources allocated to the process for determining the fair value of assigned investments, including any material changes to the roles or functions of the persons responsible for determining fair value; and
- any material changes to the adviser's process for selecting and overseeing pricing services, as well as material events related to the adviser's oversight of pricing services.

We agree that such periodic reporting should be required to be done on a quarterly basis, as these assessments are fundamental to the fair valuation provided to investors each quarter. In particular, while a fund's investment profile may be stable over time, markets are constantly changing, and therefore, we believe a quarterly reassessment of valuation risks is appropriate. For example, during the recent period of extreme market turbulence, we would expect fund boards to be reassessing valuation risks not only each quarter but more often as market conditions warrant.

2. Testing of Fair Value Methodologies Should Be Performed Quarterly

We agree with the Proposed Rule to require the testing of the appropriateness and accuracy of the methodologies used to calculate fair value. This requirement is designed to help ensure that the selected fair value methodologies are appropriate and that adjustments to the methodologies are made where necessary. We believe that the specific tests to be performed and the frequency with which such tests should be performed are matters that depend on the circumstances of each fund and thus should be determined by the board or the adviser. The Proposed Rule would require the identification of (1) the testing methods to be used and (2) the minimum frequency of the testing.

We believe that the results of testing methods such as calibration and back-testing can assist in identifying issues with methodologies applied by fund service providers, including poor performance or potential conflicts of interest. For example, if a specific methodology consistently over-values or under-values one or more fund investments as compared to observed

transactions, the board or adviser should investigate the reasons for this difference. We recognize that the specific tests to be performed depend on the circumstances of each fund; however, we believe that the SEC should specify that at a minimum, **testing should compare the fair value ascribed to the fund's investment against observed transactions or other market information, such as quotes from dealers or data from pricing services**. Testing should not be limited to "calibration" (which the SEC has defined as a comparison of fair valuation to initial purchase price) and "back-testing" (which the SEC has defined as a comparison of fair valuation to ultimate sales price). Instead, boards should look to any and all high-quality, third party, market-based information for testing purposes, prioritizing the most objective and verifiable sources and inputs in a manner similar to the "fair value hierarchy" set out in ASC 820. We believe the SEC should strive for a higher bar than in the Morgan Asset Management case referred to in the Proposed Rule, where securities were only back tested against the price at which they were ultimately sold.

In addition, we recommend that the SEC should **require that such testing be done at a minimum on a quarterly basis, or whenever financial statements are provided to investors.**

3. Boards Should Be Responsible for Recordkeeping

The Proposed Rule requires that a fund maintain, for a five-year period, the first two years in an easily accessible place, certain records relating to the fair value determination. Such records would include appropriate documentation to support fair value determinations, including information regarding the specific methodologies applied and the assumptions and inputs considered when making fair value determinations, as well as any necessary or appropriate adjustments in methodologies, as well as a copy of policies and procedures that would be required under the Proposed Rule that are in effect, or that were in effect at any time within the past five years. We support this requirement and believe that **the board should be required to maintain these records, rather than the investment adviser, as it provides evidence that the board has reviewed these documents**. We also agree that a five-year period is an appropriate retention period.

4. Prompt Reporting Requirements Are Appropriate

The Proposed Rule would also require that the adviser report to the board "promptly" on matters associated with the adviser's process that materially affect or could have materially affected the fair value of the assigned portfolio of 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. The Proposed Rule would require these reports in no event later than three business days after the adviser becomes aware of the matter. We believe this "prompt reporting requirement" is appropriate and will ensure timely reporting of important matters to the board regarding valuation issues.

B. PERFORMANCE OF FAIR VALUE DETERMINATIONS: BOARD OVERSIGHT AND SPECIFICATION OF FUNCTIONS

1. Board Oversight Should be an Active Process and be Performed by Qualified Board Members

Where a board assigns fair value determinations to an adviser, the Proposed Rule would require the board to satisfy its statutory obligation with respect to such determinations by overseeing the adviser. We strongly support the proposed guidance that boards should approach their oversight of fair value determinations assigned to an investment adviser of the fund with a skeptical and objective view, and that **oversight cannot be a passive activity.** Directors should: ask questions and seek relevant information; identify potential issues and opportunities to improve the fund's fair value processes; and take reasonable steps to see that matters identified are addressed. We also agree that boards engaged in this process should use the appropriate level of scrutiny based on the fund's valuation risk, including the extent to which the fair value of the fund's investments depend on subjective inputs: as the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, the board's level of scrutiny should increase correspondingly.

In addition, as noted above, we strongly believe that **board members must have sufficient technical expertise to perform their oversight functions**. Valuation is an extremely complex discipline, and it is also fundamental to the financial statements of investment companies. We strongly encourage the SEC to explore an initiative to require that members of an investment fund board have "valuation literacy," meaning that they must have sufficient expertise to understand and evaluate the valuation techniques and results that are performed by investment managers and other third parties who provide valuation services. We believe this will help to ensure that board members are able to adequately fulfill their oversight responsibilities, thus enhancing the reliability and accuracy of financial statements for investors.

2. Boards Should be Permitted to Assign Fair Value Determinations to Subadvisers and Other Third Parties

The Proposed Rule would permit boards to assign the determination of fair value only to an adviser to the fund. **We believe it would be acceptable to permit boards to assign these determinations to subadvisers, as well as to other third parties, such as pricing vendors or accounting firms**. In fact, we believe permitting assignment to other third parties could help boards minimize potential conflicts of interest by bringing in independent advisers that would provide an objective view on the fair valuation of positions managed by the fund's investment adviser. However, we believe that, in order to limit the issues relating to having multiple advisers assigned to the process, the SEC should limit the assignment to **"one adviser, one fund".** That is, we do not believe the SEC should permit the assignment of only particular elements of proposed paragraph (a) of § 270.2a-5 to an adviser. Otherwise, we are concerned that if a board engages multiple advisers for a single fund, the fair value methodologies and assumptions that are employed by the advisers may not be consistent, and boards may then have to reconcile a number of third party valuations.

3. Boards Should Have an Affirmative Obligation to Investigate and Manage Conflicts of Interest

The Proposed Rule also states that in overseeing the adviser's process for making fair value determinations, the board should understand the role of, and inquire about conflicts of interest regarding, any other service providers used by the adviser as part of the process and satisfy itself that any conflicts are being appropriately managed. We believe this is a fundamental aspect of the Proposed Rule because, as the Commission notes, the compensation of the investment professionals is often based on the fund's performance, and a fund's adviser may therefore have an incentive to improperly value fund assets in order to increase fees, or to improve or smooth reported returns or comply with the fund's investment policies and restrictions; and other service providers, such as pricing services or broker-dealers providing opinions on prices, may have incentives such as maintaining continuing business relationships with the adviser.

Therefore, **we believe that it is critical that the Commission should clarify that a board may not merely rely on the investment adviser's identification of such conflicts but has an affirmative duty to seek to discover conflicts of interest independently**. **We believe this is consistent with the overall goal that directors should bring to the boardroom "a high degree of rigor and skeptical objectivity to the evaluation of management and its plans and proposals," particularly when evaluating conflicts of interests. Only by firmly establishing this independent duty to identify and manage conflicts of interest will the board serve as a meaningful check on the adviser and other service providers involved in the determination of fair values and fulfill its fundamental obligation to act in the best interest of the fund.**

In addition, we believe it would be a best practice for a board to obtain written attestation from the adviser regarding its independence and freedom from conflicts of interest.

4. Specification of Functions: Portfolio Management vs. Valuation

The Proposed Rule would also require the adviser to "reasonably segregate" the process of making fair value determinations from the portfolio management of the fund, due to the inherent conflicts of interest that can exist when a portfolio manager is the most knowledgeable person at an investment adviser regarding a fund's holdings but is also compensated based on the returns of the fund. The Proposed Rule suggests that funds could institute this requirement through a variety of methods, such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel, but does not require that portfolio management be subject to a communication "firewall." **We are concerned that the segregation requirement may not go far enough to manage this very real and fundamental conflict.** We appreciate the fact that the Commission would like to allow boards the flexibility to structure their fair value determination process and portfolio management functions in ways that are tailored to each fund's facts and circumstances; however, due to the fundamental and pervasive nature of this conflict of interest, we **believe that the SEC needs to think more specifically about this issue and be more precise in its articulation of the how to avoid such conflicts**.

C. READILY AVAILABLE MARKET QUOTATIONS

1. The Final Rule Should Refer to US GAAP for All Accounting Concepts and Guidance

As the SEC notes, the board's role in the valuation of a portfolio holding for purposes of fair value depends on whether or not market quotations are readily available for such a holding. In light of the fact that the FASB has spent over a decade building a framework for the recognition, measurement and disclosure of fair value as currently codified in ASC 820, we believe that the final rule should expressly refer to U.S.GAAP for defining when a market quotation is "readily available" – that is, it should state that market quotations are readily available with respect to an investment only when the investment's value is determined under US GAAP based solely on quoted, unadjusted prices in active markets for identical investments that the fund can access at the measurement date.

We also note that one constituent[3] has noted that ASR 118 differs slightly from ASC 820 in that it provides governance on considering the size of the holding which impacts the valuation of "odd lots," and this has been central to several SEC enforcement actions involving the valuation of "odd lots."[4] To the extent the SEC determines that there is a discrepancy in these two standards, we urge the Commission to resolve any differences via appropriate rulemaking by the FASB.

2. Funds Valued Using a NAV Should Be Included in the Scope of the Rule

We believe that the final rule should also address investments in pooled vehicles that are valued using a Net Asset Value (NAV). ASC 820 permits use of the NAV as a practical expedient election only if the investment does not have a "readily determinable fair value", and the NAV is calculated consistent with the fair value measurement principles of an investment company within the scope of ASC 946, *Financial Services – Investment Companies*. Thus, it is clear that the FASB considers the application of the NAV practical expedient as consistent with fair value measurement principles, and therefore, we believe it is appropriate for the final rule to extend to investments valued using the NAV practical expedient. To exclude such investments would potentially exclude from the scope of the final rule a significant number and amount of fund investments that use this practical expedient, including hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds. Because we support the adoption of the framework set out in the Proposed Rule, we believe it should also be required for these types of funds as well.

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[3] Comment letter dated May 29, 2020 from Mr. Douglas Scheidt.

[4] As cited in Mr. Scheidt's letter, the 2016 enforcement action against PIMCO, the 2020 SEC enforcement action against Semper Capital Management Company, and the 1990 SEC enforcement action against Investors Portfolio Management.

3. Guidance on the Amortized Cost Method Should be Eliminated

The SEC notes that the Proposed Rule does not address the views the Commission has previously expressed related to the use of amortized cost in valuing portfolio securities with maturity dates of 60 days or less, such as the *2014 Valuation Guidance Frequently Asked Questions ("FAQ") FAQ #2*. Rather than codifying such guidance, we believe that this guidance should be eliminated. We believe that if a fund has the policies and procedures to review and monitor market-based factors to enable it to conclude that the amortized cost method of a portfolio security is approximately the same as the fair value of that security, then the fund should be able to produce the fair valuation for that security. Our members have consistently expressed the view that fair value is the most relevant measure for financial instruments for both short-term and long-term investors. Accordingly, we believe the guidance regarding the application of amortized cost to a fund portfolio security should be superseded, and fair value should be required to be presented for these types of portfolio securities.

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Thank you again for the opportunity to provide our input on this Proposed Rule. If you or your staff have questions or seek further elaboration of our views, please contact me at +1.212.754.8350 or by email at sandra.peters@cfainstitute.org.

Sincerely,

/s/ Sandra J. Peters

Sandra J. Peters CPA, CFA
Senior Head, Global Financial Reporting Policy
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