

May 29, 2020

VIA ELECTRONIC SUBMISSION

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

Re: File Number S7-07-20; Release IC-33845. Good Faith Determinations of Fair Value.

Dear Ms. Countryman:

I. Introduction and Summary

I am submitting this comment letter on my own behalf in response to the April 21, 2020 rulemaking proposal of the Securities and Exchange Commission (the “Commission”): Good Faith Determinations of Fair Value (Release IC-33845, April 21, 2020) (the “Proposing Release”). Among other things, the Commission announced in the Proposing Release that it proposes to rescind its prior valuation guidance, including the guidance contained in Accounting Series Release No. 118 (“ASR 118”).¹

Rescinding ASR 118 would be extremely ill-considered. As explained in greater detail below, rescinding ASR 118 would allow funds to inflate the value of their odd lot positions and thus freely engage in the fraudulent and manipulative valuation practices that have been the subject of several SEC enforcement actions, most notably the 2016 enforcement action against PIMCO,² the 2020 SEC enforcement action against Semper Capital Management Company,³ and the 1990 SEC enforcement action against Investors Portfolio Management.⁴

II. My Background and Qualifications to Comment on Valuation Issues

¹ Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118 (Dec. 23, 1970) [Investment Company Act Release No. 6295 \(Accounting Series Release No. 118\)](#)

² Pacific Investment Management Company LLC, Investment Advisers Act Release No. [IA-4577](#) (Dec. 1, 2016) (settled).

³ Semper Capital Management, LP, Investment Advisers Act Release No. [IA-5489](#) (Apr. 28, 2020)(settled).

⁴ Investors Portfolio Management, Inc., Investment Advisers Act Release No. 13890, [50 S.E.C. 251](#) (June 26, 1990) (Commission opinion).

From 1997 through 2018, I served as the Chief Counsel and Associate Director in the SEC's Division of Management, and from 1991 through 1996, I served as the Assistant Director in the Division's Office of Enforcement Liaison. I am currently an Adjunct Professor at Howard University School of Law and an Adjunct Professor at the Raymond A. Mason School of Business at the College of William & Mary, where I have taught and will teach courses on Investment Management Regulation. I also am a consultant and expert witness on issues arising under the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

As Chief Counsel, I was deeply involved in valuation matters and I was the Division of Investment Management's expert on valuation issues. First, I was the principal legal officer within the Division on all legal and interpretive issues relating to valuation. In that role I authored all of the valuation-related guidance issued by the Division, including the April 2001 letter to the Investment Company Institute (ICI)⁵ and the December 1999 letter to the ICI.⁶ Second, I reviewed and substantively shaped many of the valuation-related rules issued by the Commission, including the valuation guidance embedded within the adopting releases.⁷ Third, I drafted comprehensive valuation guidance (over 100 pages long) for internal use within the SEC; that guidance has been used extensively by SEC staff when addressing and resolving valuation-related issues.⁸ Finally, on a regular and continuous basis, I advised the staff of the Division of

⁵ [April 2001 Letter to the ICI Regarding Valuation Issues](#) [December 1999 Letter to the ICI Regarding Valuation Issues](#)

⁶ [December 1999 Letter to the ICI Regarding Valuation Issues](#)

⁷ See, e.g., *Compliance Programs of Investment Companies and Investment Advisers*, [Investment Company Act Release No. 26299](#) (Dec. 17, 2003) (adopting rule 38a-1)(funds are required to adopt policies and procedures that require monitoring for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments. Funds may be required to fair value portfolio securities if an event affecting the value of the security occurs after the market closes but before the fund prices its shares); *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*, [Investment Company Act Release No. 26418](#) (Apr. 19, 2004) (adopting amendments to Form N-1A and other registration forms)(Funds generally must fair value portfolio securities for which market quotations are not readily available (including when they are not reliable); *Mandatory Redemption Fees for Redeemable Fund Securities*, [Investment Company Act Release No. 26375A](#) (Mar. 5, 2004); *Mutual Fund Redemption Fees*, [Investment Company Act Release No. 26782](#) (Mar. 11, 2005) (proposing and adopting rule 22c-2)(valuation requirements under the Investment Company Act are critical to ensuring that opportunities for arbitrage through short-term trading are diminished)(funds must adopt and implement policies and procedures designed to prevent violation of the federal securities laws, including the valuation requirements under the Investment Company Act; *Money Market Fund Reform; Amendments to Form PF*, [Investment Company Act Release No. 31166](#) (July 23, 2014)(addresses valuation of thinly traded securities, including that funds holding debt securities generally should not fair value debt securities at par or amortized cost based on the expectation that the funds will hold those securities until maturity, if the funds could not reasonably expect to receive approximately that value upon the current sale of those securities under current market conditions. Also addresses fund use of evaluated prices provided by third-party pricing services to assist them in determining fair values of portfolio securities, including considerations in choosing a pricing service and in using evaluated prices provided by a pricing service.)

⁸ I also have authored several articles concerning valuation in investment company industry publications. See, e.g., Douglas Scheidt and J. Lynn Taylor, *An Analysis of Fair Valuation in the Context of the SEC's Enforcement Action Against the Morgan Keegan Fund Directors*, *The Investment Lawyer*, Vol. 25, No. 6, June 2018; Douglas Scheidt, *Whither Valuation Guidance?*, *Fund Board Views*, Dec. 6, 2019, available at http://fundboardviews.com/Content_Free/Viewpoints-Scheidt-valuation.aspx. In addition, on behalf of the SEC, I made many presentations at investment company industry conferences and seminars on the topic of valuation. See,

Enforcement and the Commission on *all* of the valuation-related enforcement actions (several dozen) brought by the Commission during the period from late 1991 through mid-2018, including actions against fund advisers, fund directors and valuation services.⁹

III. The Specific Problem with Rescinding the Commission’s Prior Valuation Guidance in ASR 118

In each of the SEC enforcement actions against PIMCO,¹⁰ Semper Capital Management and Investors Portfolio Management, the funds’ investment advisers (a) purchased substantial amounts of odd lot positions (*i.e.*, small-sized pieces) that traded at discounts to round lot positions (*i.e.*, larger-sized pieces) of the same securities and (b) immediately marked up the values of the odd lot positions to the higher values of the round lot positions, even though the funds were not able to sell the odd lot positions at those higher values. These actions materially increased the funds’ net asset values per share and the funds’ performance. The Commission found that the funds’ investment advisers had overstated the values of the funds’ odd lot positions and, as a result, caused the funds to sell and redeem their shares at prices that were not based on their net asset values, in violation of rule 22c-1 under the Investment Company Act.¹¹ The Commission also found that the actions of the funds’ investment advisers violated various antifraud provisions of the federal securities laws.

The positions taken by the Commission in these enforcement actions were based upon – and indeed they were dependent upon -- the valuation guidance contained in ASR 118. In ASR 118, the Commission stated that to determine the fair value of securities in compliance with the Investment Company Act, “it is incumbent upon the Board of Directors [of a fund] to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered” After specifying some of the general factors that fund directors should consider in determining a valuation method for an individual issue of securities, the Commission identified “specific factors which are to be considered,” including the “size of the holding.”

The “size of the holding” valuation guidance is the critical guidance in ASR 118 that formed the basis of the 2016 SEC enforcement actions against PIMCO, the 2020 SEC enforcement action against Semper Capital Management and the 1990 SEC enforcement action against Investors Portfolio Management. That guidance requires every fund to consider the number of shares that it owns of an issuer when fair valuing those securities. In essence, the fund investment advisers in the enforcement actions acted in violation of the Investment

e.g., *Valuation Trends: Squaring Industry Practices with Regulatory Expectations*, ICI 2014 Mutual Funds and Investment Management Conference, Orlando, FL, March 2014. *Valuation Issues*, ICI 2005 Mutual Funds and Investment Management Conference, Palm Desert, CA, March 2005.

⁹ These enforcement actions are listed here: [Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies](#) Select Bibliography of the Division of Investment Management at section V.

¹⁰ I worked very closely with the staff of the Division of Enforcement on the 2016 SEC enforcement action against PIMCO, and I actively assisted the staff of the Division of Enforcement in articulating the theories of the violations in that action, as reflected in the Commission’s enforcement order.

¹¹ Rule 22c-1 prohibits registered investment companies, among others, from the sale, redemption, or repurchase of any redeemable security except at a price based on the current net asset value of such security.

Company Act and contrary to the SEC valuation guidance in ASR 118 when they valued the funds' smaller odd lot positions at the higher valuations of the larger round lots, because they failed to take into account the smaller sizes and lower values of the funds' odd lot positions.

Under U.S. GAAP and FASB ASC Topic 946,¹² however, the result of the SEC enforcement actions would have been different: indeed, there would have been no enforcement actions because the valuations of the funds' odd lot positions would have conformed with GAAP and Topic 946. Both GAAP and Topic 946 specify that funds and others use the values of round lot positions when valuing their odd lot positions; they do not permit funds and others to consider the size of their odd lot positions when valuing those securities. More specifically, under GAAP and Topic 946, the funds would have been required to value their odd lot positions at the higher valuations of the round lot positions, even though the funds were not able to sell their odd lot positions at the higher values of the round lot positions.¹³

Accordingly, if the Commission were to rescind ASR 118, funds would no longer be required to consider the size of their holdings when valuing their odd lot positions, and they would no longer be prohibited from valuing their odd lot positions at the higher values of the corresponding round lot positions. Funds instead would be required to value their odd lot positions at the higher values of the corresponding round lot positions, even though they could not sell their odd lot positions at those higher values, because GAAP and Topic 946 would direct them to do so. In other words, funds that invest in odd lot positions would be permitted to inflate the value of their odd lot positions and thus would be free to engage in the fraudulent and manipulative practices that the Commission condemned in the 2016 SEC enforcement actions against PIMCO, the 2020 SEC enforcement action against Semper Capital Management and the 1990 SEC enforcement action against Investors Portfolio Management.

The Commission's proposed rescission of ASR 118 appears to be based upon a serious misunderstanding that GAAP and Topic 946 adequately address all fund-related valuation issues. They do not. In general, while GAAP and, in particular, Topic 946, may adequately address valuation-related issues that arise for public operating companies that must determine their asset values only a few times each year, they do not adequately address all of the valuation-related issues that arise for open-end funds that are required by the Investment Company Act of to

¹² FASB Accounting Standard Codification Topic 820: *Fair Value Measurement*.

¹³ I specifically raised this issue in an article that I wrote and published in late 2019: "Some funds have questioned whether a fund may value an unrestricted security at a "block discount" or "block premium" (i.e., a discount from the readily available market quotations for that security based solely on the large size of the fund's holding relative to the average daily trading volume of the security, or a premium to the readily available market quotations for that security based solely on the large size of the fund's holding relative to the total number of the issuer's outstanding securities, respectively). Prior SEC guidance suggests that funds, when valuing their portfolio securities, should take into consideration the number of shares of portfolio securities that they own, [footnote omitted] whereas FASB guidance would suggest otherwise. The SEC also has indicated in an enforcement action that funds are required to fair value portfolio securities that are owned in "odd lots." [footnote omitted]. *The SEC should issue guidance concerning whether, and if so under what circumstances, funds may use block discounts or premiums to value large holdings of portfolio securities, and whether funds are required to fair value portfolio securities that are owned in "odd lots."*" Douglas Scheidt, *Whither Valuation Guidance?*, Fund Board Views, Dec. 6, 2019, available at http://fundboardviews.com/Content_Free/Viewpoints-Scheidt-valuation.aspx

calculate their net asset values each and every business day.¹⁴ As a result, the Commission has occasionally found it necessary to issue its own valuation-related guidance under the Investment Company Act to supplement and supersede valuation-related guidance under GAAP and Topic 946. As the Commission has specifically stated, “conformity with the ASR 118 is required by Commission rules and complies with Generally Accepted Accounting Principles...”¹⁵ In other words, valuation guidance issued by the Commission “trumps” GAAP and Topic 946.

The valuation-related guidance in ASR 118, as reflected in the SEC enforcement actions noted above, directly addresses a specific valuation-related issue that arises for open-end funds that must accurately calculate their asset values on a daily basis, and it supersedes valuation-related guidance under GAAP and Topic 946. The guidance in ASR 118 is directed at ensuring that (a) redeeming shareholders do not receive too much or too little when they redeem their fund shares and (b) investors purchasing fund shares do not pay too much or too little for those shares. The valuation-related guidance in GAAP and Topic 946, in contrast, does not take into consideration the issues unique to open-end funds that are required to calculate their net asset values on a daily basis and which continuously sell and redeem their shares at their net asset values per share. Instead, the valuation guidance in GAAP and Topic 946 is generally addressed to the situations of operating companies, which are not required to – and do not – calculate their asset values on a daily basis and which are not engaged in continuously selling and redeeming their shares.

IV. Conclusion and Recommendation.

Rescinding ASR 118 would be extremely ill-considered. At a minimum, the Commission should preserve the guidance in ASR 118 that requires funds to consider the size of their securities positions when fair valuing those positions. It also would be extremely prudent for the Commission to carefully comb through all of its valuation guidance – as well as its valuation-related enforcement actions -- to identify any other similar issues that would arise from rescinding that guidance.

Very truly yours,

/S/

Douglas Scheidt

¹⁴ See rule 22c-1 under the Investment Company Act.

¹⁵ PIMCO, *supra*, at n. 4.