SEWARD & KISSEL LLP

901 K STREET, NW
WASHINGTON, DC 20001

TELEPHONE: (202) 737-8833
FACSIMILE: (202) 737-5184
WWW.SEWKIS.COM

ONE BATTERY PARK PLAZA
NEW YORK, NEW YORK 10004
TELEPHONE: (212) 574-1200
FACSIMILE: (212) 480-8421

July 20, 2020

Ms. Vanessa A. Countryman
Secretary
United States Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

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

Dear Ms. Countryman:

Seward & Kissel LLP ("Seward & Kissel")[1] appreciates the opportunity to submit this letter in response to a request for comment by the United States Securities and Exchange Commission (the "Commission") on proposed new rule 2a-5 (the "Proposed Rule") under the Investment Company Act of 1940 (the "1940 Act").[2] The Proposed Rule would address valuation practices and the role of the board of directors with respect to the fair valuation of the investments of registered investment companies and business development companies ("BDCs") (together "funds"). Seward & Kissel commends the Commission's initiative in proposing a new rule that would establish a framework for fund valuation practices and clarify how fund boards can satisfy their fair valuation obligations, including through the assignment of day-to-day fair valuation responsibilities, subject to board oversight of the entity to which the assignment is being made.

We generally support the Commission's efforts in developing the Proposed Rule. We would like, however, to offer some recommendations and highlight certain areas that we believe could benefit from clarification. First, while we support the Proposed Rule's objective of codifying the ability of fund boards to assign fair valuation functions, we believe that limiting the scope of the assignment provision to a fund's investment adviser as the only permissible assignee is too narrow. The rule should allow boards the flexibility to exercise judgment as to the type of entity that is best suited to perform fair valuation functions. Second, absent a history of widespread

[1] Seward & Kissel is a leading United States law firm with offices in New York City and Washington, DC. We represent a variety of asset management organizations, including some of the largest mutual fund complexes, and serve as counsel to investment advisers of registered funds and to independent directors and trustees of registered funds.

[2] *See* Good Faith Determinations of Fair Value, Rel. No. IC-33845 (April 21, 2020), 85 F.R. 28734 (May 13, 2020) (the "Release").

inferior investment valuations resulting from current practices, which the Commission does not suggest in the Release, we believe that the Proposed Rule is unnecessarily prescriptive. Third, we believe the Release's discussion of the role of the board regarding fair valuation policies and procedures under the Proposed Rule and under rule 38a-1 of the 1940 Act ("Rule 38a-1") is confusing and needs to be clarified. Lastly, we believe that the definition of "fair value" in section 2a-5(e) of the Proposed Rule should be revised to be consistent with the use of "fair value" in the text of the Proposed Rule and with section 2(a)(41) of the 1940 Act.

Rule 2a-5 Should Allow the Board to Assign Fair Valuations to Entities Other than Investment Advisers

The Release recounts the Commission's consideration of alternative provisions to those contained in the Proposed Rule, including the potential assignment of fair valuations to service providers other than investment advisers, citing pricing service vendors as an example of possible alternative service providers. The Commission states that using such service providers for fair valuations potentially could limit a board's ability to effectively oversee the service provider because "the board does not have the same level of visibility, access to information, and control over the actions of service providers other than the investment adviser."[3] The Commission further notes that, "even though service providers may have a contractual obligation to perform valuation services for the fund, those service providers, unlike an adviser to a fund, may not owe a fiduciary duty to the fund, and thus their obligation to serve the fund's and its shareholders' best interests is limited."[4]

An investment adviser's primary responsibility is to manage the day-to-day investments of the fund. A board may believe that the assignment of fair valuations to the adviser will detract from the adviser's time and focus on its primary responsibility. A board may also believe that an adviser does not have the financial resources, technology, staff, and expertise required to effectively perform the day-to-day valuation tasks required to determine fair valuations. As the Commission acknowledges in the Release, determining fair valuations today often requires greater resources and expertise than it has in the past and has grown more complicated given market and regulatory developments over the years.[5] The Commission also acknowledges that advisers may have potential conflicts of interest that may bias fair valuations. Due to a possible incentive to improperly value fund investments in order to improve or smooth investment returns, an adviser may have an inherent conflict of interest in providing fair valuations. An adviser may also overstate the value of fund assets to increase management fees, which are typically calculated based on the value of assets under management. In light of these considerations, a board may determine that it is not in the best interests of the fund for the adviser to assume responsibility for fair valuation functions and may wish to assign these functions to another entity whose policies and procedures have been approved by the board pursuant to Rule 38a-1.

While most fair valuation functions currently are performed with the assistance of investment advisers, assigning fair valuation functions to investment advisers in all instances would be inconsistent with current fund practices both for some series funds with a common

[3] Release at 106.
[4] Id.
[5] Id. at 13.

adviser and, to our knowledge, for all series funds with investment advisers unaffiliated with each other and the funds' administrator ("umbrella trusts"). Assignment to an investment adviser in these cases might lead to the establishment of a disparate fund valuation structure for each fund (particularly in the case of umbrella trusts), as opposed to assigning fair valuations to a third party that can implement a more consistent, uniform and efficient valuation approach. Assigning fair market valuations to investment advisers could also lead to conflicts in fair market valuations within funds in the case of multi-manager funds. The Proposed Rule should take a broader view of the entities or bodies that may serve as assignees of fair valuation responsibilities. For example, other entities that are affiliates of a fund's investment adviser (*e.g.*, entities that provide administrative services, such as fund accounting) and committees composed of personnel or officers of the fund, investment advisers, and relevant affiliated entities whose policies and procedures are subject to board oversight pursuant to Rule 38a-1 should be permitted to assume these responsibilities. In particular, permitting fund personnel and officers to carry out fair valuation responsibilities is a necessary accommodation for the small number of funds that are internally managed, as well as for umbrella trusts. The current practice for a significant number of funds reflects this structure, which is based on a fund administrator appointed by the board to assist and perform calculations for the board in connection with its fair valuations and which could be adapted easily to an assignment relationship.

We note also that because fair value determinations are ministerial in nature, they are not an activity to which the application of a fiduciary duty has generally been deemed necessary. As a result, these determinations could be performed by an adviser under an administrative services agreement distinct from an advisory agreement and not be subject to a fiduciary duty standard. We recognize that in some cases fund administrators may be compensated based on a percentage of fund assets serviced, which may pose conflicts of interests similar to those that would be present for an adviser, but we believe that the amounts involved, and therefore the conflicts, for a fund administrator are less significant than those for an adviser.

We believe that a fund administrator can effectively execute the functions required under the Proposed Rule and not compromise the board's ability to oversee the fair valuation of fund investments, and we are aware of fund administrators currently assisting funds in doing so. Although administrators are not directly regulated by the Commission, we note that, under Rule 38a-1(a)(2), the fund board specifically approves policies and procedures of the fund administrator and determines that they are reasonably designed to prevent violations of the federal securities laws. Under this scenario, the board already has significant visibility into, and information relating to, the fund administrator's operations and is discharging its oversight duties in a regulatorily sound manner.

If the board were to assign fair valuations to the fund administrator under section 2a-5(b) of the Proposed Rule, the administrator would be subject to board oversight under the Proposed Rule and report to the board just as the adviser would if the board were to assign the fair valuations to the adviser; in addition, the board would have approved the administrator's policies and procedures under Rule 38a-1, and the fund would have a contract to receive services from the administrator. A board would also be able to request follow-up information when appropriate and take necessary steps to ensure that fair valuation matters were being addressed properly. Also,

fund administrators typically involve other parties, such as advisers and pricing service vendors in seeking to achieve accurate fair valuations.

While not precluding the involvement of advisers in fair valuation activities, a more expansive and accommodating approach would permit fund complexes to leverage valuation expertise that does not reside entirely within investment advisory firms. It would also be especially useful to smaller fund complexes and umbrella trusts, which then would have additional means to ensure that portfolio managers do not exert undue influence on the fair valuation process.

We believe that some advisers may be reluctant or unwilling to perform fair valuations because of the complexity, expense and difficulty in creating "silos" to isolate investment management activities from pricing and fair valuations within the same entity. This in turn may lead to an adviser charging higher fees for providing fair valuation services, whether as part of the adviser's fee or as a separately priced service, than the fees for performing fair valuations charged by an independent entity such as an administrator that has in place a substantial fair valuation capability. In such instances, boards may wish to believe that a party other than the adviser is best suited to perform fair valuations.

Lastly, we note that the Commission recognizes that a unit investment trust ("UIT") does not have a board of directors or investment adviser[6] but requires the trustee to conduct the fair valuations under section rule 2a-5(d) of the Proposed Rule and does not allow the trustee to assign fair valuations. The Commission, however, does not address the potential challenges a trustee may encounter performing fair valuation functions, even though the Commission readily acknowledges the growing complexity of valuation and the in-depth expertise that may be required to accurately fair value investments.[7] We further note that the Commission does not address the assignment of fair valuations for internally managed funds (*e.g.*, BDCs that do not have investment advisory contracts with external investment advisers). In light of the challenges regarding performing fair valuation functions, we believe that UITs and internally managed funds should be able to assign fair valuation functions to an assignee. We believe these examples reinforce the need for rule 2a-5 to permit the assignment of fair valuation functions to entities, other than investment advisers, whose policies and procedures have been approved by the board.

The Proposed Rule Is Unnecessarily Prescriptive

We understand that the objective of the Proposed Rule is to modulate the role of boards in fair valuations, not to replace the existing framework for fair valuations. In light of that objective, the Proposed Rule is unnecessarily prescriptive and potentially unduly burdensome, particularly for smaller fund complexes, and may lead to overly complicated procedures, documentation and records. This would reduce a fund's flexibility to design policies and procedures for fair valuation, board reporting and recordkeeping that best meets the valuation needs of a particular fund. The Proposed Rule's degree of regulation does not appear necessary to achieve accurate and unbiased fair valuations and may unnecessarily increase expenses and enhance a fund's risk of compliance violations. Boards currently rely on assistance from investment advisers and fund administrators in both pricing and fair value determinations, and we are not aware, nor does the Release suggest,

[6] Id. at 16.
[7] Id. at 70.

that resulting NAV calculations have been inferior in general or have led to widespread pricing issues.

Currently, when a board appoints entities such as an investment adviser or fund administrator to assist the board with fair valuation, the fair value policies and procedures are subject to board oversight pursuant to Rule 38a-1. The Proposed Rule prescribes more specific elements for fair value policies and procedures than the current legal framework under Rule 38a-1 requires. The nature and number of requirements for fair valuation should not change when the engagement changes from obtaining assistance from the entity to assigning fair valuation functions to the entity, in either case subject to the oversight of the board. While the Commission indicates it desires a certain minimum, consistent framework for fair valuations and standard of baseline practices across funds, we note that funds have implemented different approaches based on their particular operations and needs. Absent prevalent problems with fair valuations in the fund industry, it is not clear why funds should be subjected to the expense of developing conforming, detailed valuation frameworks seemingly for the primary purpose of achieving conformity and consistency.

In addition to specific requirements under the Proposed Rule being potentially unduly burdensome, we believe that certain requirements may pose practical challenges for compliance by a fund and may hinder the fair valuation process. Section 2a-5(a)(2)(A) of the Proposed Rule would require selecting and applying in a consistent manner an appropriate methodology or methodologies for determining (and calculating) the fair value of fund investments, including specifying (1) the key inputs and assumptions specific to each asset class or portfolio holding, and (2) the methodologies that will apply to new types of investments in which a fund intends to invest. Although the Release indicates that there can be circumstances in which it is appropriate to adjust methodologies,[8] the Proposed Rule suggests that the valuation methodology or methodologies, along with key inputs and assumptions for each asset class or portfolio holding, be specifically identified in fair value policies and procedures. This could be problematic if the adviser needs to apply a new methodology to an investment under changed circumstances and if that methodology is not yet reflected in the policies and procedures of the entity performing fair valuations. Under these circumstances, the flexibility and discretion of the entity performing fair valuations to apply the most appropriate methodology may be limited. Similarly, with respect to new investments, the entity could be similarly limited or challenged if it is unable to anticipate and establish all methodologies necessary for types of investments in which a fund intends to invest. These situations illustrate the need for rule flexibility, and the desire for consistency in methodologies should not override the interest in the accuracy of fair valuations.

Lastly, given the prescriptive nature of the Proposed Rule and the overall tone of the Release, we are concerned that adherence to the Commission's suggestions and guidance on practices in the Release may be imposed, even though not specifically required by the Proposed Rule, and not necessarily relevant to accurate fair valuations. For example, section 2a-5(b)(1)(i) of the Proposed Rule imposes requirements regarding the frequency and content of specific board reports, and the Release cites a laundry list of items that a board could also review and consider in addition to the minimum required items, such as reports analyzing trends in the number of the fund's portfolio holdings that received a fair valuation, and reports on the number and materiality

[8] Id. at 21.

of securities whose fair valuations were determined based on information provided by broker-dealers.[9] Final rule 2a-5 should allow boards to determine the timing and content of the board reports, given the experience of fund boards and current practices. In addition, section 2a-5(a)(3) of the Proposed Rule requires the testing of fair valuation methodologies, and the Release references calibration, back-testing and stale price analysis. The final rule should not encourage an inflexible testing regime that would apply to all portfolios and securities; flexibility should be encouraged, as certain portfolios or securities may require more or less rigorous testing.

In short, we do not believe that the Proposed Rule's requirements are necessary for boards to effectively meet their fair valuation obligations and to protect funds and their beneficial owners.

The Role of the Board and the Scope of Its Oversight When the Board Assigns Fair Valuations Is Unclear

When the board assigns fair valuations to an entity, section 2a-5(b)(1) of the Proposed Rule requires that the board oversee the entity, but under the Proposed Rule the scope of the oversight is confused with the requirements that apply to the entity in performing its fair valuation obligations. The text of the rule should clearly disclose that the board's responsibility is limited to oversight when the board assigns fair valuations, and that the requirements of this oversight responsibility are separate from the requirements for the assignee to carry out its duties.

When the board assigns fair valuations to an entity under section 2a-5(b) of the Proposed Rule to an entity that is specified under Rule 38a-1, fair value policies and procedures are adopted and implemented by the entity subject to board oversight under the Proposed Rule. The Release should clarify the interaction between Rule 38a-1 and the policies and procedures under the Proposed Rule, insofar as Rule 38a-1 encompasses a fund's compliance obligations with respect to the Proposed Rule. We note the Release states that "[t]o the extent that adviser policies and procedures under proposed rule 2a-5 would otherwise be duplicative of fund valuation policies under rule 38a-1, a fund could adopt the rule 2a-5 policies and procedures of the adviser in fulfilling its rule 38a-1 obligations."[10] But if the board has assigned fair valuations, the fund would no longer be making these determinations, so the valuation policies would not be duplicative to the extent that the policies relate to making, rather than overseeing, fair value determinations. The fund's role in the valuation policies and procedures would be limited to board oversight, while the assignee's role would relate to fund valuations, which would be mandated by rule 2a-5 requirements and Rule 38a-1 procedures. In this regard, the board would oversee the adviser in accordance with rule 2a-5(b)(1) and approve, pursuant to Rule 38a-1, the adviser's rule 2a-5 policies and procedures based on a finding that such policies and procedures are reasonably designed to prevent violation of the federal securities laws. This approach reflects the Commission's position in the adopting release for Rule 38a-1 indicating that Rule 38a-1 requires fund boards to approve the policies and procedures of fund service providers, and requires a fund's policies and procedures to include provisions for the fund's board to oversee compliance by the fund's service providers.[11]

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[9] Id. at 46-47.

[10] Id. at 28. The Proposed Rule does not contemplate an administrator acting as assignee of the fair valuation function.

[11] *See* Compliance Programs of Investment Companies and Investment Advisers, SEC Release No. IC-26299, 68 F.R. 74714 (Dec. 24, 2003), at 74717.

The Definition of "Fair Value" is Inconsistent with the Use of the Term in the Text of the Proposed Rule and in Section 2(a)(41) of the 1940 Act and Should be Revised

The definition of "fair value" in section 2a-5(e) of the Proposed Rule is inconsistent with the use of the term in the text of the Proposed Rule and in section 2(a)(41) of the 1940 Act.[12]

Section 2(a)(41) requires funds to value their portfolio investments using the market value of their portfolio securities when market quotations for those securities are "readily available," and, when a market quotation for a portfolio security is not readily available, by using the fair value of that security, "*as determined* [emphasis supplied] in good faith by the board of directors."[13] In general, the text of the Proposed Rule properly reflects "fair value" as a result of a process for determining the value of fund investments, not merely as the residue of concluding that the security does not satisfy the requirements of paragraph (c). The treatment of "fair value" as the result of a board determination is consistent with the description of "fair value" in section 2(a)(41) and is reflected in the Proposed Rule by using "fair value" in phrases such as "fair value determinations" or "determining fair value" in almost all instances when the term is used.

We believe that the definition of "fair value" in section 2a-5(e) of the Proposed Rule should accord with the text of the Proposed Rule and reflect the process described in section 2(a)(41). Accordingly, section 2(a)(5)(e)(2) of the Proposed Rule should be revised and restated as follows:

> "*Fair value* means the value of a portfolio investment for which market quotations are not readily available under paragraph (c) of this section *that is determined pursuant to this section* [emphasis supplied]."

In addition, we believe that two unmodified references to "fair value" in the Proposed Rule (in sections 2a-5(a)(2)(iii) and 2a-5(b)(1)(ii)) should be changed to "fair value determinations" for purposes of consistency and accuracy.

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Please feel free to contact Patricia A. Poglinco at (212) 574-1247, Paul M. Miller at (202) 661-7155, Robert M. Kurucza at (202) 661-7195, Anthony C.J. Nuland at (202) 661-7140, Lancelot A. King at (202) 661-7196 or Christopher D. Carlson at (202) 661-7165 with any questions about this letter.

Very truly yours,

/s/ Seward & Kissel LLP

Seward & Kissel LLP

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[12] We note also that Rule 2a-4 under the 1940 Act contains the same modifier of fair value, "as determined in good faith by the board of directors . . .", as section 2(a)(41)(B)(ii) of the 1940 Act.
[13] *See* Release at 5.