July 21, 2020

VIA ELECTRONIC SUBMISSION

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

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

Dear Ms. Countryman:

We appreciate the opportunity to comment on the Securities and Exchange Commission’s (the “Commission’s”) proposed new Rule 2a-5 under the Investment Company Act of 1940, as amended (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 registered investment companies (the “Proposal”).

The Capital Group Companies is one of the oldest and largest privately held investment management organizations in the United States with more than 85 years of investment experience. Through our investment management subsidiaries, we actively manage equity and fixed income investments in various collective investment vehicles and institutional client separate accounts globally. The vast majority of these assets consist of the American Funds family of mutual funds, which are U.S. regulated investment companies managed by Capital Research and Management Company. We are an active manager that uses rigorous fundamental research to find attractive investments and manage risks.

We commend the Commission for taking this significant and comprehensive step forward towards addressing the developments in fund valuation, which have become increasingly complex and complicated due to the evolution of financial markets, fund investment strategies and financial instruments since the Commission last addressed valuation in 1970. We support the Commission’s efforts to provide boards and advisers with a modernized approach to fair value determination. We also are pleased to see the Commission recognizes the board’s role in valuation generally should be that of oversight, not day-to-day management, and proposes a rule that permits the assignment of day-to-day valuation responsibilities to the fund’s adviser, which reflects current valuation practices and industry standards.

While we agree with the general framework of proposed Rule 2a-5, we support the comments submitted by the audit committee chairs of the American Funds, the Investment Company Institute (the “ICI Letter”) and the Asset Management Group of the Securities
Industry and Financial Markets Association (the “SIFMA Letter”). As discussed further below, we are concerned that the Proposal’s binary approach to the definitions of fair value and readily available market quotations is overly broad and fails to capture the significantly different levels of valuation risks and challenges between Level 2 and Level 3 securities (e.g., investment grade fixed income and private equity securities). To avoid the negative repercussions of this binary approach, we recommend that the Proposal allow funds and advisers to rely on third party pricing vendors’ fair value methodologies without having to review and approve each individual methodology and their key inputs and assumptions, subject to the fund or the adviser, as applicable, overseeing, monitoring and evaluating these pricing providers.

In addition, although many of the elements of the Proposal, including the adequacy of the adviser’s valuation processes and procedures, are currently being performed by advisers and overseen by fund boards, certain prescriptive features of the Proposal would require fund boards to be involved in managing various aspects of the fair valuation process rather than focusing on oversight. We urge the Commission to reconsider these prescriptive features, which we believe are not necessary for fund boards to properly oversee the fair valuation process, and, in practice, are more likely to reduce the fund board’s effectiveness. We also believe that the Proposal should be revised to clarify that when a fund board assigns valuation responsibilities to the adviser, the fund board’s role in fair valuation is limited to satisfaction of its oversight responsibilities, and thus the board should not be liable for any failure by the fund adviser to properly manage the fair valuation process.

In light of the above, we offer the following comments on specific aspects of the Proposal.

I. The Proposal should reflect the significant differences in valuation risks between Level 2 and Level 3 securities.

We support Rule 2a-5 not requiring a single methodology for determining fair value. In our experience, many fair valued securities are unique, such that different facts and circumstances may necessitate a fund to employ different methodologies to value a security. We also agree with the Commission in recognizing accounting developments like ASC Topic 820 that have established a framework for the recognition, measurement, and disclosure of fair value under U.S. GAAP. The Proposal’s connection with ASC Topic 820, however, should not end there.

The Proposal should reflect the Level 1, 2, 3 category framework under accounting and auditing standards. The manner in which the Proposal merges the three levels of valuation risks under ASC Topic 820 into two for purposes of the 1940 Act does not reflect the significant practical differences in valuation risks between Level 2 and Level 3 securities. Most Level 2 security prices are from unadjusted, third-party evaluated prices based on observable market data whereas most Level 3 security prices derive from methodologies and inputs subject to adviser discretion due to the absence of observable market data.

Furthermore, requiring Level 2 and Level 3 securities to be treated the same under Rule 2a-5 is impractical, significantly increases operating burdens, and fails to provide relevant and tailored information for board oversight. The universe of securities required to be fair valued would increase significantly from current practices for fixed income and equity...
fund strategies. For example, as of March 31, 2020, approximately 0.3% of total securities held by the American Funds in aggregate were Level 3 securities (0.1% of total market value). If adopted as proposed, the funds would be required to fair value over 90% of total securities (over 40% of total market value). Moreover, it is not unusual for non-U.S. equity strategies to have more than 50% of their portfolios subject to non-U.S. price adjustments due to significant U.S. market moves, which under the Proposal’s construct would mean a majority of the portfolio would be comprised of fair valued securities on any given day.

Due to the rule, advisers would have to pay additional fees to receive from pricing service providers specific methodologies, key inputs, and assumptions used to price Level 2 securities. Even assuming the advisers do receive such information, it would be unduly burdensome to require advisers to document and retain the methodologies used each business day to price thousands of fixed income securities (and tens of thousands for investment advisers of larger funds) in a manner that, under the rule, “would be sufficient for a third party to verify the fair value determinations.”

We support the bifurcated approach recommended in the ICI Letter for Level 2 and Level 3 securities. Under this approach, advisers that rely on evaluated prices from third-party pricing vendors (subject to the fund's review thresholds and processes) may rely on pricing services’ methodologies and their application thereof, while also permitting advisers to establish and apply their own methodologies for specified investments as necessary and appropriate (e.g., Level 3 investments). In addition, detailed recordkeeping to support fair value determinations only would apply to those investments for which the fund (including the fund board or any assignee) establishes and applies its own methodologies (e.g., for Level 3 investments).

We also believe that the Proposal should not interfere with existing, well established Rule 17a-7 cross-trade rules and guidance which, unlike the Proposal, treat Level 2 and Level 3 securities differently. The proposed rule does not explicitly address the applicability of the definition of “readily available market quotations” to other provisions of the 1940 Act, particularly Rule 17a-7 which exempts certain cross trades of securities “for which market quotations are readily available.” We understand that the Commission has included in its Regulatory Flexibility Act Agenda potential recommendations to propose amendments to Rule 17a-7. We believe that the Commission should explicitly note that Rule 2a-5 is not intended to interfere with existing Rule 17a-7 cross-trade practices and the no-action letters related thereto.

II. The Proposal should be less prescriptive and more principles-based.

A. Assess and Manage Valuation Risks

We support the proposed rule’s requirement for funds to assess and manage valuation risks, including material conflicts of interest. Given the reality that specific valuation risks depend on facts and circumstances, we believe the rule would benefit from taking a less prescriptive and more principles-based approach. Valuation is a critical function of funds, and fund boards have already been relying on advisers to perform certain valuation functions, subject to their oversight. Instead of requiring boards to “periodically” assess valuation risks under the Proposal, we recommend that this requirement be amended to “no
less frequently than annually,” to be consistent with Rule 38a-1 under the 1940 Act, giving boards and advisers ability to tailor to their facts and circumstances at hand.

We have concerns with adding more prescriptive risk assessment requirements, including higher frequencies for reassessment, and strongly believe that such frequency should be determined at the discretion of the adviser. The proposed requirements would force advisers to provide, and boards to review, hundreds of pages of information that could be allocated to more impactful matters. Board responsibilities should be more focused on monitoring conflicts of interest and other more important matters rather than delving into the day-to-day nuances of valuation performed by the adviser.

B. Establish and Apply Fair Value Methodologies

The proposed rule differs from several recent Commission rules by highlighting numerous prescriptive elements to establishing and applying fair value methodologies, rather than taking a principles-based approach. Contrary to what is contemplated in the Proposal, valuation is not always performed by applying a single methodology for all assets within the same asset class. We find the requirement that methodologies must be applied in a “consistent” manner problematic because the adviser has the expertise and knowledge to determine when an alternative methodology is more suitable and results in a more representative fair value price. Application of methodologies should be dependent on facts and circumstances applied in a reasonably consistent manner when deemed appropriate, and the Proposal fails to consider that certain investments like private placements may have unique features that do not support applying the same methodologies across the asset class. While the release recognizes that valuation methodologies for the same investment or class of investments may change over time due to market events, changes in available inputs, etc., the rule text does not. Requiring that one methodology is applied to all assets within the same class would ultimately be inconsistent with the notion of good faith standards.

The requirement to specify “which methodologies apply to new types of fund investments in which a fund intends to invest” is not feasible for all asset classes such as unlisted equity investments and restructured debt securities where the unique characteristics of the investment make it impossible to predetermine which methodologies to apply. We recommend that advisers, with proper board oversight, have flexibility to determine the appropriate approach to fair valuing securities for which no methodology exists and a proper methodology would potentially need to be created.

C. Testing of Fair Value Methodologies

We support the Commission permitting the adviser to exercise discretion in testing the appropriateness and accuracy of fair value methodologies and agree that tests type and minimum frequency of testing should be determined by the adviser with appropriate board oversight. Prescribing weekly or monthly frequency could cause undue burdens with minimal benefits depending on the facts and circumstances, such as availability of market data and level of risk. Back-testing is most useful if there are sufficient data points to provide context, trends, and other analysis to evaluate if policies, procedures, or pricing vendor methodologies are appropriate or if adjustments are needed. For example, if a security is halted due to a new share offering, the methodology used to fair value may be based on weighted average prices, the price of the last trade prior to halt, or the offer price. In such
scenarios, too frequent of reporting would cause undue burden on the adviser and would not provide any meaningful context to the board until enough datapoints (likely meaning at least 6-12 months) are present. If a specific frequency would be required, we would support testing at least annually.

D. Pricing Services

We support the Commission necessitating oversight and evaluation of pricing service providers to help ensure that their pricing information is a reliable input for fair value determinations. As the focus of the rule should be directly on pricing, however, the rule should only cover pricing service providers.\(^1\) Additionally, we support further clarification from the Commission concerning who would qualify as a pricing service provider in order to separate and exclude those providers that do not directly provide evaluated prices or similar estimates but provide supplemental and collaborative information related to fair valuing securities.

In addition to requiring oversight of pricing services, the proposed rule would require that the adviser establish criteria for initiating price challenges and the release suggests establishing objective thresholds as a tactic to do so. We believe this requirement overstates the importance of price challenges in evaluating pricing services. This should be left to the discretion of the adviser, taking into account that the criteria for initiating price challenges are not always objective given the myriad of different sources that could lead to challenges (e.g., market news, trade price, broker quotes, spreads derived from observable market comparable securities, credit events, etc.). Establishing specific criteria such as objective thresholds to determine when a price challenge should be initiated would lead to less telling and more rote processes.

E. Fair value processes and procedures

As discussed earlier, many elements alluded to in the Proposal are currently done by the adviser and overseen by the board, including the appropriateness and effectiveness of the adviser’s fair value processes and procedures. We recommend a more flexible and principles-based approach where fund directors are deemed to have fully performed their duties under Section 2(a)(41) of the 1940 Act in good faith when the board fulfills its oversight responsibilities pursuant to Rule 38a-1 under the 1940 Act and consistent with the Commission’s oversight position in Rule 22e-4. The board should not be liable for any failures by the fund adviser to properly manage the fair valuation process, provided that sufficient oversight exists.

F. Permissible Assignees

The proposed rule would permit fund boards to assign fair value determinations to an adviser, or one or more sub-advisers, subject to board oversight. While we believe that, in certain circumstances, it could make sense to assign valuation responsibilities to a sub-

\(^1\) Since all investment firms in the industry rely on the same pricing services, in lieu of burdening thousands of funds to individually assess and review the methodology, key inputs, and assumptions for each security priced by a vendor, we encourage the Commission to consider ways it can review and assess these pricing services to ensure the reliability of their prices and facilitate effective regulatory oversight.
adviser, we share similar concerns detailed in the SIFMA Letter. Sub-advisers that do not currently assume fair value responsibilities may need to make substantial changes to investment advisory agreements, policies and procedures, and resources among other areas to make adequate and effective fair value determinations discussed in the Proposal. Furthermore, allowing boards the flexibility to delegate fair value determinations to sub-advisers could introduce additional operation inefficiencies and complications, which might require the sub-adviser to need daily interaction with a fund’s pricing agent which is not within the purview of a sub-adviser’s typical duties.

We recommend that the Commission provide further guidance on the role a sub-adviser could assume in fair value determinations and clarify who would be responsible for performing reconciliations in the event multiple sub-advisers have differing opinions on the most appropriate fair value methodology to be used for the same investment.

III. The Proposal should clearly delineate the board’s oversight roles and responsibilities versus the adviser assigned day-to-day management of fair valuation determinations and tailor board reporting to facilitate effective and efficient oversight.

A. Board Oversight and Liability

We support the Commission’s efforts to modernize the regulatory approach to valuation - that it is a function that boards must oversee, but the complexity, volume, and time constraints of modern fair valuation tasks are better served at the adviser level. We believe that it is important for boards to have relevant and tailored information to ensure effective oversight of fund valuation and appreciate that Rule 2a-5 provides flexibility for how information can be provided (e.g., summaries, dashboards, etc.).

As written, however, the Proposal’s prescribed requirements for board valuation activities, including those concerning fair value methodologies, pricing services, and reporting, undercut the board’s oversight role, and would cause the board to “get in the weeds” of daily functions more appropriate for the adviser. In our experience, responsible fund boards review in detail all reports and data provided in order to fulfill their duties to funds and fund shareholders and avoid second-guessing. We believe that the Proposal’s mandatory reporting requirements will lead to voluminous disclosure to boards, which would serve to obscure rather than illuminate material and/or pressing valuation matters. Moreover, this prescriptive approach may increase the potential liability of fund boards – any breach of the rule’s requirements would expose the board to liability for failing to fair value in good faith.

We recommend that the Commission clarify that (1) Rule 2a-5 would not change the potential liability associated with fair valuation for funds, boards, and advisers and (2) under Rule 2a-5, a board’s role is limited to satisfying its oversight responsibilities for fair valuation, and it will not be held liable for issues related to adviser determinations so long as the board fulfilled its oversight responsibilities. We also recommend that if the Commission decides to retain the prescriptive approach, then Rule 2a-5 should operate as a safe harbor, making clear that there are other reasonable methods outside of the rule for boards to satisfy the statutory requirement to determine fair value in good faith.
B. Periodic Board Reporting

The Proposal's reporting requirements should be tailored to facilitate effective and efficient oversight by the board. As proposed, the reporting requirements would distract boards from areas where director oversight is most valuable and duplicate functions that the adviser would perform and supervise (e.g., pricing services). Instead of tailoring information boards currently receive, the Proposal would expand what is currently provided to most boards. Assessment of most risks and resources do not change quarter to quarter, making mandated quarterly reporting a rote exercise with reduced effectiveness.

We support the recommendation in the ICI Letter that all reporting be annual, except for quarterly reports on (1) material changes to valuation risks or adviser-applied fair value methodologies (or material deviations therefrom); and (2) significant deficiencies or material weaknesses in the fair value determination process. We also would anticipate providing such additional information as the board and the adviser may determine is appropriate under the specific circumstances. Serious lapses in an adviser’s fair valuation processes should be promptly reported, once discovered and verified.

We also support the ICI’s recommendation to remove from any adopting release that reports are required, at a minimum, to include the factors listed in the release. They are rightly not included in the rule text, as these can be helpful considerations for fund boards but may not be relevant depending on the fund’s facts and circumstances. Mandating certain requirements will not provide the type of information most effective for board oversight and fund resources, and, as noted above, may obscure more pertinent information.

The utility of quarterly reporting to the board on valuation risks, methodologies, back-testing, resources, pricing vendors, etc. could be minimal, particularly in light of the high volume of information such reporting would likely create and the resources required to create them. For example, if Rule 2a-5 fails to differentiate between the risks and related valuation requirements for Level 2 and Level 3 securities, the quarterly reporting requirement could necessitate the creation of high volumes of information or reports with minimal takeaways for board consideration, defeating the rule’s purpose to provide relevant and tailored information for board oversight of the adviser.

Furthermore, valuation resource assessments are more useful in coordination with other important resource and budget analyses performed annually by the adviser and fund boards in line with Rule 38a-1.

In our experience, certain topics do not require quarterly reporting and engagements with the board. For example, back-testing reports are most useful if there are sufficient data points to provide context, trends, and other analysis to evaluate if policies, procedures, and pricing vendor methodologies are appropriate or if adjustments are needed. In most cases, quarterly reporting of back-testing results would be comprised of too small of a data set to provide American Fund boards salient information for their oversight. For example, fair valuation back-testing data points comparing in a variety of ways the fair value price to the open price when security resumes trading could amount to single digit data points annually. While quarterly reporting of this data could be somewhat informative to the adviser’s valuation committee’s day-to-day management of the fair valuation process given their
expertise and appreciation of the limited nature of the data, quarterly reports of this data to the board would not be as valuable for their oversight.

    Requiring all price overrides and challenges be reported to the board is overly prescriptive and would not produce helpful information for effective board oversight. For example, while the number of price challenges can depend on many factors (e.g. market volatility), recent monthly averages of price challenges indicate that mandating this type of reporting could result in quarterly reports with thousands of data points for board members to review. As with other data provided to the board, reporting of trends, outliers, and similar analysis of price overrides and challenges would be more telling to fund boards. In our experience, pricing service oversight, due diligence, and related assessments are currently reported to the board annually. We believe it would be reasonable for the board to rely on the adviser’s due diligence and evaluation of pricing service providers.

The Proposal notes that the adviser could discuss instances where it challenged pricing information as a material valuation risk for fund directors to assess quarterly. In practice, board approved valuation policies and procedures already address the circumstances why the adviser would challenge a third-party vendor price, leaving quarterly reporting a less efficient use of fund resources and board attention. Even though an adviser may challenge a vendor price, that does not mean that the vendor services are subpar or that the adviser will exercise discretion to deviate from that vendor price. In short, a difference in vendor pricing versus adviser’s viewpoint is not necessarily an indicator of potential material valuation risks, vendor quality issues, or conflicts of interest. Rather, day-to-day interactions with vendors serve as part of the ongoing evaluation process, such as dual pricing and comparing vendors against each other constantly. It is a normal market practice that is indicative of both quality vendor oversight by an adviser and appropriate outreach for input by the pricing vendor and is intended generally speaking to improve prices on the margins.

C. Prompt Board Reporting

We believe the proposed prompt reporting requirements are problematic and reiterate our support of the ICI’s recommendation that serious lapses in an adviser’s fair valuation processes should be promptly reported, once discovered and verified. In our view, prompt reporting to the fund board should be dependent on the facts and circumstances, as is current practice.

Promptly reporting in 3 business days what “could have materially affected” fair value as outlined in the Proposal is highly speculative and would not lead to quick and clear conclusions. For example, consider pricing exceptions related to potentially impactful news. In our experience, news about a company that touches on an existing fair valued security may evolve over a series of days, with new facts each day informing what the fair valuation would have been. Another example is the reassessment of the fair valuation of private placements or equity from debt restructures that may have been impacted by COVID-19 market events. Revisiting the valuations can involve reaching out to the company for the latest financial data available (most of which would not have been available at the time given the delay in receiving financial statements generally in the COVID-19 shutdown). In both scenarios, the adviser needs time to investigate the information, confer with investment analysts, operations, and related reports, analyze with the fair valuation committee, and more. To
report to the board without sufficient information and analysis would be premature and not an effective use of board engagement.

We disagree with the Commission’s assertion that “significant increases in price challenges or overrides” would fit into this new standard requiring prompt reporting. Rather, it is more appropriate for advisers to manage and supervise price overrides and operational events under its assignment and inform the board as needed as part of its periodic reporting.

If the Commission cannot support this view, we recommend that at the very least that Rule 2a-5 provide longer than 3 business days to promptly report to the board on matters materially affecting fair value (e.g., at least 10 business days). The current 3-day timing is too short, even with the rule’s allowance of 3 business days for verification and final determination before board notification. In practice, it can take several business days to understand and evaluate a matter and whether it could have materially affected the larger portfolio of investments/subset of the portfolio. This includes coordinating analysis from valuation experts, fund accounting, operations, legal and compliance, all while maintaining daily fund services. We appreciate that the proposed 3 business days timeframe is consistent with the prompt reporting requirements under liquidity Rule 22e-4 and proposed derivatives Rule 18f-4. However, in those cases, prompt reporting is required under breaches of a bright line test (e.g., 15% illiquid threshold breach). That is not the case in this rule where prompt reporting requires more complex analysis.

IV. We support the rescission of prior Commission releases and Commission and staff guidance.

We agree with the Commission for continuing to modernize the investment company rulebook through the rescission of prior guidance incorporated in and superseded by the Proposal. To that end, we recommend that the Commission make clear that the guidance on board oversight of pricing vendors included in the 2014 adopting release for Money Market Reform is withdrawn and/or is superseded by the Proposal’s final rule requirements and related guidance.

We also note that with the rescission of Accounting Series Release No. 113 and Accounting Series Release No. 118, auditors would no longer be required to perform a confirmation of the existence and ownership of 100% of the investments in a fund’s portfolio. We appreciate the flexibility this would afford fund boards but anticipate fund boards may continue to request 100% coverage depending on the facts and circumstances.

V. The Proposal would significantly increase current operating burdens and costs with little benefit to the valuation process and board oversight.

We believe that the Proposal’s prescriptive oversight and reporting requirements could have significant economic impacts, with increased operating burdens and costs and little benefit from an oversight perspective. Requiring fund boards to wade through voluminous spreadsheets and numerous reports does not necessarily improve, and in this case, will likely decrease board oversight and focus. This is particularly but not exclusively the case if Level 2 securities are required to be considered fair valued given the requirements relating to back-testing, calibration, and evaluation of inputs and methodologies, which may require advisers
to develop additional tools and capabilities. To the extent increased costs are passed on to shareholders, we see little commensurate benefit.

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We applaud the Commission in its efforts to modernize the framework for fund valuation practices and appreciate the opportunity to comment on the Proposal. If you have any questions regarding our comments, please feel free to contact Brian C. Janssen at [redacted] or Nelson N. Lee at [redacted], Co-Chairs of our Fair Valuation Committee.

Sincerely,

Brian C. Janssen
Vice President
Capital Research and Management Company

Nelson N. Lee
Senior Vice President & Senior Counsel
Capital Research and Management Company

cc: The Hon. Jay Clayton, Chairman
    The Hon. Hester M. Peirce, Commissioner
    The Hon. Elad L. Roisman, Commissioner
    The Hon. Allison Herren Lee, Commissioner

Dalia O. Blass, Director, Division of Investment Management

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