HARVEST
Transparent Investment Valuations

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Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609
Transmitted via email: rule-comments@sec.gov

Re. Securities and Exchange Commission
Request for Comments, Investment Company
Reporting Modernization File S7-08-15

Dear Members of the Securities and Exchange Commission:

Thank you for the opportunity to comment on the SEC's Request for Public Comment on the Investment Reporting Modernization Proposal, File S7-08-15. Harvest Investments, Ltd. welcomes the Commission's extensive efforts to update financial reporting for alternative mutual funds and ETFs. We also appreciate the Commission's goal of enhancing portfolio transparency in this key sector of our financial system in the service of overall stability. As an independent securities valuation specialist, we are deeply familiar with the challenges of simultaneously assessing both quality and quantity of information within the valuation process. In what follows, we will focus on the Commission's proposals related to the valuation and pricing of securities, demarcating several areas of concern based upon our extensive experience with financial reporting, the valuation of complex securities, and the current regulatory environment. More specifically, our comments will be focused on the questions the Commission poses about proposed changes in reporting of fair value on Form N-PORT (pp. 66-7), as well as the questions concerning the related changes in Articles 12 and 13 of Regulation S-X (p. 129). Because these questions converge on the same issues, we will be addressing them in tandem.

We begin by observing that the form of the Commission's proposal may have implications for the content of the expanded information desired from the funds in question. Organized and presented as if one were looking at a series of database fields or tables, it is guided by a desire to standardize data so that it can be integrated into a database. Given the scope and scale of the proposed undertaking, these parameters are hardly surprising. But the Commission's approach also results in a marked emphasis on the form of data ahead of considerations as to its content or quality. This emphasis on data form is echoed by the accompanying claims that enhanced transparency will be achieved via the implementation of Form N-PORT: transparency is associated with the correct amalgamation and ordering of large amounts of data, as if it were principally a consequence of quantity. If the Form N-PORT is intended to map out in finer detail a sector that is increasingly integral to our financial system as a whole, then the thinking that informs it should be as attentive to the quality of inputs as it is to their form and quantity.

An important aim of the proposed N-PORT documentation is to enable the collection and correlation of information concerning portfolio composition and valuation on a monthly basis. Given the importance of valuation and its centrality to overall system transparency and stability, we are concerned that the proposal too hastily relegates complex issues of valuation to the periphery. On p. 62 of the proposal, the following statement appears: "[e]ach fund would also report whether the investment is categorized by the fund as a Level 1, Level 2, or Level 3 fair value measurement in the fair value hierarchy under U.S. Generally Accepted Accounting Principles ("U.S. GAAP")", along with an accompanying footnote (n. 101) referring the reader to ASC 820 and its requirement that levels be designated according to the lowest level input. We support the Commission's proposed amendments to Regulation S-X requiring that "funds identify level 3 securities in their schedules of investments." But we caution the Commission not to take it for granted that fair valuation and ASC 820 leveling are currently being undertaken in conformity with ASC 820. In practice, we have observed considerable nonconformity.

While we understand how an emphasis on data collection might propel the assumption that practice is in strict accord with guidance, Harvest's experience indicates significant, general nonconformity with ASC 820 across a wide range of securities. We respectfully yet insistently call the Commission's attention to current discrepancies between guidance and actual practice, because they bear directly on the ways that fair valuation is implicated in issues of systemic risk and investor risk exposure. In order for Form N-Port to function as a bellwether for systemic security flows and risks, as the Commission envisions, the underlying valuation issues should be identified and addressed directly.

Harvest routinely sees unreasonable variances in the values of many security types each year. We frequently see mispricings of the agency mortgage pools we review, which are core investments for banks. We also see variances in auction rate bonds 45% of the time, in lower grade non-agency CMOs 37% of the time, and in newly issued non-agency CMOs 23% of the time. These variances underscore lingering problems with valuation, pricing, and the fair value hierarchy that we urge the Commission to confront before issuing its final proposal.

In our experience, the vast majority of meaningful variances we discover are due to inappropriate market comparisons and/or inputs. On leveling, present guidance clearly stipulates, "[t]he level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability."[1] Nevertheless, some within the financial reporting community will default to a level 2 designation as an expedient on a significantly wide range of instruments simply based on issuer sector or pricing source rather than the relevant inputs, even though the standards clearly state that appropriate designation of levels depends on the lowest level input used in a valuation (as the Commission rightly notes). Under present practice - which, again, often diverges from guidance - investors are often unwittingly

[1] FASB *Statement of Financial Accounting Standards No. 157*, p. 12 (www.fasb.org)

exposed to level 3 investments, even though ASC 820 was specifically formulated to highlight and document such risks and exposures. Although significant progress has been made with respect to valuation since the financial crisis, Harvest remains very concerned that the levels of each input are frequently not being calculated at all, or that they are not being calculated correctly. The complex matrix methodologies used by pricing sources both trigger and reinforce such variances, because they are proprietary rather than transparent. Persistent problems with level assignment in the fair value hierarchy could undermine the Commission's goals in calling for increased reporting under the N-PORT regimen.

The Commission asks (pp. 66-7) what types of disclosures should be included on Form N-PORT to "improve the transparency regarding the liquidity and valuation of investments" and whether additional disclosures about fund valuation practices are warranted. Harvest strongly agrees that information about primary pricing sources should be made available, and supports disclosures identifying exchanges, broker quotes (which are technically considered level 3), third-party pricing service, and/or internal fair valuation. Harvest also supports a requirement that third-party pricing services should be named, and that such information be disclosed on an individual security basis. Investors would benefit from such information because it draws attention to assigned levels and valuations, as well as their accuracy, especially when it comes to unobservable inputs and illiquid securities. But again, these reasonable efforts in the service of transparency will only be effective if the underlying practices of primary pricing services are in strict conformity with existing guidance. If inputs, levels, and values are mistaken, then investors may be unwittingly exposed to significant risks. Accordingly, we urge the Commission to address the widespread lack of understanding of valuation methodologies within its proposal, along with the ways in which the quality and accuracy of a valuation can be conditioned by source.

Our concerns about valuation and the relatively minor role it plays in the current proposal are rooted in our observations of present practices, which are generally (if not exclusively) marked by a lack of attention to the quality of inputs and a lack of transparency regarding methodology. Awareness of these deficiencies, as well as their relevance to situations of contagion and crisis, informs our work as an engaged securities valuation specialist. Harvest applies a consistent, documented approach, so that all inputs as well as the reasoning behind all inputs are clearly available to our clients for review. In this way, our methods and results constitute an open rather than proprietary book, in which one can find clear documentation of and rationale for each input. Such measures ensure a high degree of transparency within our valuation processes. But not all pricing sources provide this level of transparency.

We are concerned that the increased frequency of reporting that the Commission is proposing will result in the further routinization (and possibly even expansion) of the problems of input quality and lack of methodological transparency. If the Commission envisions a comprehensive monthly portfolio valuation from each reporting entity, but does not make further stipulations about inputs and methodologies, these entities will continue to rely heavily on matrix pricing services and the specific kinds of information they can provide. These services are currently a primary source of the input and valuation problems we have indicated above, because they are algorithmically driven and reliant on proprietary methodologies that are embedded in particular software environments. Further, many pricing sources do not disclose ASC 820 levels. The general lack of transparency with respect to matrix-driven processes of valuation and leveling often extends to those producing the prices, who often do not have adequate understanding of either the data generated or the methods used.

In recognition of issues arising from pricing and valuation, the European Union has recently introduced a system that clearly distinguishes between pricing and valuation, with pricing services understood as providing an "administrative" service, rather than a detailed, qualitative assessment of the kind provided by valuation specialists.[2] In this way, investors and others can tell which prices are generated algorithmically and proprietarily, and which are the result of detailed analysis. We call the Commission's attention to this development because it underscores the basic importance of questions of pricing transparency that we recommend be addressed within the Commission's proposal.

We are grateful to the Commission for the opportunity to comment on its proposal, and for its time in considering our arguments and concerns. If the Commission would be interested in discussing any of our views in more detail, we are at its disposal: please contact Susan DuRoss at 312-823-7051.

With best regards,

Harvest Investments, Ltd.

[2] See: Regulation (EU) No 575/2013, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32013R0575; also, Regulation (EU) 2015/534 of the European Central Bank (17 March 2015) on reporting of supervisory financial information (ECB/2015/13)
https://www.bankingsupervision.europa.eu/ecb/legal/pdf/oj_jol_2015_086_r_0004_en_txt.pdf