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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210 and 270

[Release No. IC-33845; File No. S7-07-20]

RIN 3235-AM71

Good Faith Determinations of Fair Value

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (“Commission”) is proposing a new rule (“rule 2a-5”) under the Investment Company Act of 1940 (the “Investment Company Act” or the “Act”) that would address valuation practices and the role of the board of directors with respect to the fair value of the investments of a registered investment company or business development company (a “fund”). The proposed rule would provide requirements for determining fair value in good faith with respect to a fund for purposes of section 2(a)(41) of the Act. This determination would involve assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; overseeing and evaluating any pricing services used; adopting and implementing policies and procedures; and maintaining certain records. The proposed rule would permit a fund’s board of directors to assign the fair value determination to an investment adviser of the fund, who would then carry out these functions for some or all of the fund’s investments. This assignment would be subject to board oversight and certain reporting, recordkeeping, and other requirements designed to facilitate the board’s ability effectively to oversee the adviser’s fair value determinations. The proposed rule would include a specific provision related to the determination of the fair value of

investments held by unit investment trusts, which do not have boards of directors. The proposed rule would also define when market quotations are readily available under section 2(a)(41) of the Act. If rule 2a-5 is adopted, the Commission would rescind previously issued guidance on the role of the board of directors in determining fair value and the accounting and auditing of fund investments.

DATES: Comments should be submitted on or before July 21, 2020.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/interp.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-07-20 on the subject line.

Paper Comments:

- Send paper comments to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-07-20. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/interp.shtml>). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available.

Studies, memoranda or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at www.sec.gov to receive notifications by e-mail.

FOR FURTHER INFORMATION CONTACT: Joel Cavanaugh, Senior Counsel; Bradley Gude, Senior Counsel; Thoreau A. Bartmann, Senior Special Counsel; or Brian McLaughlin Johnson, Assistant Director, at (202) 551-6792, Investment Company Regulation Office, Division of Investment Management; Kieran G. Brown, Senior Counsel, or David J. Marcinkus, Branch Chief, at (202) 551-6825 or IMOCC@sec.gov, Chief Counsel's Office, Division of Investment Management; Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549. Regarding accounting and auditing matters: Jenson Wayne or Alexis Cunningham, Assistant Chief Accountants, or Jacob Sandoval, Branch Chief, at (202) 551-6918 or IM-CAO@sec.gov, Chief Accountant's Office, Division of Investment Management, Securities and Exchange Commission; or Jamie Davis or Thomas Collens, Professional Accounting Fellows, at (202) 551-5300 or OCA@sec.gov, Office of the Chief Accountant, Securities and Exchange Commission.

SUPPLEMENTARY INFORMATION: The Commission is proposing for public comment 17 CFR 270.2a-5 (new rule 2a-5) under the Investment Company Act.

TABLE OF CONTENTS

I. INTRODUCTION

II. DISCUSSION

A. Fair Value as Determined in Good Faith Under Section 2(a)(41) of the Act

1. Valuation Risks
2. Fair Value Methodologies

3. Testing of Fair Value Methodologies
4. Pricing Services
5. Fair Value Policies and Procedures
6. Recordkeeping
- B. Performance of Fair Value Determinations
 1. Board Oversight
 2. Board Reporting
 3. Specification of Functions
 4. Records of Assignment
- C. Readily Available Market Quotations
- D. Rescission of Prior Commission Releases
- E. Existing Staff No-Action Letters, Other Staff Guidance, and Proposed Transition Period

III. ECONOMIC ANALYSIS

- A. Introduction
- B. Economic Baseline
 1. Current regulatory framework
 2. Current practices
 3. Affected parties
- C. Benefits and Costs and Effects on Efficiency, Competition, and Capital Formation of Proposed Rule
 1. General economic considerations
 2. Benefits
 3. Costs
 4. Effects on efficiency, competition, and capital formation
- D. Reasonable Alternatives
 1. More principles-based approach
 2. Assignment of responsibilities to service providers other than investment advisers
 3. Not permit boards to assign fair value determinations to an investment adviser
- E. Request for Comment

IV. PAPERWORK REDUCTION ACT ANALYSIS

- A. Introduction
- B. Policies and Procedures
- C. Board Reporting

- D. Recordkeeping
- E. Proposed Rule 2a-5 Total Estimated Burden
- F. Request for Comment

V. INITIAL REGULATORY FLEXIBILITY ANALYSIS

- A. Reasons for and Objectives of the Proposed Actions
- B. Legal Basis
- C. Small Entities Subject to Proposed Rules
- D. Projected Reporting, Recordkeeping, and Other Compliance Requirements
 - 1. Policies and Procedures
 - 2. Recordkeeping
 - 3. Board Reporting
- E. Duplicative, Overlapping, or Conflicting Federal Rules
- F. Significant Alternatives
- G. Request for Comment

VI. CONSIDERATION OF IMPACT ON THE ECONOMY

VII. STATUTORY AUTHORITY

I. INTRODUCTION

The Investment Company Act 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 in good faith by the fund’s board.¹ The aggregate value of a fund’s investments is the primary determinant of the fund’s net asset value (“NAV”), which for many funds determines the price at which their shares are offered and

¹ Section 2(a)(41) of the Investment Company Act. *See also* Investment Company Act rule 2a-4.

redeemed (or repurchased).² Accordingly, proper valuation, among other things, promotes the purchase and sale of fund shares at fair prices, and helps to avoid dilution of shareholder interests.³ Valuation also affects the accuracy of funds' asset-based and performance-based fee calculations;⁴ disclosures of fund fees, performance, NAV, and portfolio holdings;⁵ and compliance with investment policies and limitations.⁶ As a result, improper valuation can cause

² The Investment Company Act requires registered investment companies that issue redeemable securities to sell and redeem their shares at prices based on the current net asset value of those shares. *See* section 22(c) of the Investment Company Act and rule 22c-1(a) thereunder. Rule 2a-4 defines the term "current net asset value" of a redeemable security issued by a registered investment company and provides, similar to section 2(a)(41)(B), that "[p]ortfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company." Rule 22c-1(a) requires open-end funds to sell, redeem, or purchase shares at a price based on their current NAV next computed following receipt of an order.

Although closed-end funds are not subject to rules 2a-4 and 22c-1 under the Investment Company Act, section 23(b) limits the ability of closed-end funds to sell their common stock at a price below current NAV. Section 23(c) of the Investment Company Act provides for the repurchases of closed-end fund shares. The shares of closed-end funds (including business development companies ("BDCs")) that are listed on an exchange often trade at a premium or discount to NAV. *See* Item 1.1(i) of Form N-2 (requiring closed-end funds whose securities have no history of public trading to include "a statement describing the tendency of closed-end fund shares to trade frequently at a discount from net asset value").

³ *See* Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016) ("Liquidity Risk Management Release") (adopting rule 22e-4 under the Investment Company Act and noting "the risk of shareholder dilution associated with improper fund pricing").

If fund shares are overpriced, selling shareholders will receive too much for their shares, and purchasing shareholders will pay too much for their shares. On the other hand, if fund shares are underpriced, selling shareholders will receive too little for their shares, and purchasing shareholders will pay too little for their shares. *See generally* Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 136-38 (1940) (discussing the effect of dilution on fund shareholders).

⁴ *See* section 205 of the Investment Advisers Act of 1940 ("Advisers Act") (permitting a fund's adviser to receive compensation based upon the total value of the fund and permitting certain specified types of performance fee arrangements with funds).

⁵ *See, e.g.*, Item 3 of Form N-1A (requiring annual fund operating expenses to be disclosed in the fund's prospectus as a percentage of the value of a shareholder's investment); Item 4(b)(2) of Form N-1A (requiring certain disclosures about fund performance in fund prospectuses); Item 4.1 and Instruction 4.b. to Item 24 of Form N-2 (requiring disclosure of the fund's NAV in its prospectus and annual report); Item 6 of Form N-CSR and § 210.12-12 of Regulation S-X (requiring a schedule of the fund's investments, including the value of the investment, in the fund's annual report).

⁶ *See* Rule 22e-4(b)(1)(iv) (generally prohibiting an open-end fund from acquiring an illiquid investment if such investment would cause more than 15% of such fund's net assets to be invested in illiquid

investors to pay fees that are too high or to base their investment decisions on inaccurate information.⁷

For these reasons, a number of the substantive requirements of the Investment Company Act relate to investment company valuation.⁸ Moreover, the federal securities laws impose liability on funds, fund boards, and advisers for improperly valuing fund investments and for making material misstatements regarding a fund's valuation procedures.⁹ Properly valuing a fund's investments also is a critical component of the accounting and financial reporting for investment companies.¹⁰ Section 2(a)(41)(B) defines "value" for purposes of many of the requirements of the Investment Company Act as: (i) with respect to securities for which market

investments). *See also* Liquidity Risk Management Release, *supra* footnote 3; Instruction 4 to Item 9(b)(1) of Form N-1A (requiring a fund to disclose any policy to invest more than 25% of its net assets in a particular industry or group of industries).

⁷ Fund advisers may have an incentive to overvalue fund assets, for example, to increase fees, but also in some cases may have incentives to undervalue fund assets, for example to smooth reported returns or comply with investment policies and restrictions. *See In re Piper Capital Management, et al., Investment Company Act Release No. 26167 (Aug. 26, 2003) (Commission opinion) ("Piper")* ("the record shows that Respondents determined to smooth or ratchet down gradually the Fund's NAV over a period of days. It appears that Respondents sought to prevent an abrupt drop in the Fund's NAV as a result of updating the stale prices."). *See also* Gjergi Cici, et al., *Missing the Marks? Dispersion in Corporate Bond Valuations Across Mutual Funds*, 101 J. Fin. Econ. 206 (2011) (observing evidence of price smoothing behavior in mutual funds and expressing concern that such smoothing may result in sub-optimal investment decisions) ("Cici et al. 2011").

⁸ *See infra* footnote 11.

⁹ *See, e.g.*, 15 U.S.C. 77l(a)(2); 15 U.S.C. 77k; 15 U.S.C. 78j(b); 15 U.S.C. 80a-33(b); 17 CFR 240.10b-5; 17 CFR 270.22c-1(a); 17 CFR 210.4-01(a)(1); 17 CFR 275.206(4)-8.

Section 206(1) of the Advisers Act makes it unlawful for an investment adviser to employ any device, scheme or artifice to defraud any client or prospective client. Section 206(2) of the Advisers Act makes it unlawful for an investment adviser to engage in any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client. The Commission has brought enforcement actions under sections 206(1) and/or 206(2) of the Advisers Act against advisers for material misstatements or omissions to a fund's board (such as the failure to disclose that the adviser is not complying with the fund's stated valuation procedures) or willfully or recklessly aiding and abetting the misvaluing of fund investments. *See, e.g.*, *In re Morgan Asset Management, et al., Investment Company Act Release No. 29704 (June 22, 2011) (settlement) ("In re Morgan Asset Management")*.

¹⁰ Rule 6-02(b) of Regulation S-X defines the term "value" to have the same meaning as in section 2(a)(41)(B) of the Investment Company Act.

quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors.¹¹

The Commission last comprehensively addressed valuation under the Investment Company Act in a pair of releases issued in 1969 and 1970, Accounting Series Release 113 (“ASR 113”) and Accounting Series Release 118 (“ASR 118”).¹² ASR 113 addressed a number of federal securities law and accounting topics related to the purchase of restricted securities by funds, including how to determine fair value¹³ for such securities. A year later, ASR 118

¹¹ Section 2(a)(41) of the Investment Company Act defines “value” with respect to the assets of registered investment companies. Section 59 of the Investment Company Act makes section 2(a)(41) applicable to BDCs. Section 2(a)(41)(A) provides the definition of “value” under the Investment Company Act for purposes of whether an issuer is an investment company under section 3, is a “diversified company” or a “non-diversified company” under section 5, or exceeds certain investment limitations under section 12. Section 28(b) of the Investment Company Act contains provisions for the valuation of the investments of face-amount certificate companies. Section 2(a)(41)(B) defines value for all other purposes under the Investment Company Act. Section 2(a)(41)(A)(iii) provides that investments acquired after the last preceding quarter shall be valued at the cost thereof. In certain circumstances, section 2(a)(41) permits directors to determine in good faith the value of securities issued by controlled companies even though market quotations are available for such securities.

¹² Statement Regarding “Restricted Securities,” Accounting Series Release No. 113 (Oct. 21, 1969); Accounting for Investment Securities by Registered Investment Companies, Accounting Series Release No. 118 (Dec. 23, 1970). In 1982, the Commission codified ASR 113 and ASR 118 in the “Codification of Financial Reporting Policies” as section 404.04: “‘Restricted’ Securities” and section 404.03: “Accounting, Valuation and Disclosure of Investment Securities,” respectively. *See* Codification of Financial Reporting Policies, Investment Company Act Release No. 12376 (Apr. 15, 1982) (codifying certain existing Accounting Series Releases, including ASR 113 and ASR 118). ASR 113 and ASR 118 continue to be included in the list of interpretive releases relating to the Investment Company Act found in 17 CFR Part 271 as Investment Company Act Release Nos. 5847 and 6295, respectively. We refer to the releases herein as ASR 113 and ASR 118.

¹³ We generally use the term “fair value” in this release as that term is used in the definition of “value” in the Investment Company Act, that is, the value of securities for which no readily available market quotations exist. *See* section 2(a)(41) of the Investment Company Act and *supra* footnote 11.

In contrast to the Investment Company Act, FASB Accounting Standard Codification Topic 820: *Fair Value Measurement* (“ASC Topic 820”) uses the term “fair value” to refer generally to the value of an asset or liability, regardless of whether that value is based on readily available market quotations or on other inputs. Accordingly, when we use the term fair value in the release we are using it to mean fair value as defined under the Investment Company Act, unless we specifically note that we mean fair value under ASC Topic 820, such as in the sections below that discuss proposed rescission of the accounting guidance. *See also infra* notes 30 and 141.

expressed the Commission's views on certain valuation matters, including accounting and auditing, as well as the role of the board in the determination of fair value.

The Commission acknowledged in ASR 113 and ASR 118 that the board need not itself perform each of the specific tasks required to calculate fair value in order to satisfy its obligations under section 2(a)(41). However, under ASR 113 and ASR 118 the board chooses the methods used to arrive at fair value, and continuously reviews the appropriateness of such methods.¹⁴ In addition, the Commission stated that boards should consider all appropriate factors relevant to the fair value of securities for which market quotations are not readily available.¹⁵ Finally, the Commission stated that whenever technical assistance is requested from individuals who are not directors, the findings of such individuals must be carefully reviewed by the directors in order to satisfy themselves that the resulting valuations are fair.¹⁶

Since ASR 113 and ASR 118 were issued, markets and fund investment practices have evolved considerably. Funds now invest in a greater variety of securities and other instruments, some of which did not exist in 1970 and may present different and more significant valuation

¹⁴ ASR 118 at 19988 (“it is incumbent upon the Board of Directors . . . to determine the method of arriving at the fair value of each such security”). *See also* Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014) (“2014 Money Market Fund Release”) at n.896 (citing ASR 118). In ASR 113, the Commission similarly stated:

“It is the responsibility of the board of directors to determine the fair value of each issue of restricted securities in good faith While the board may, consistent with this responsibility, determine the method of valuing each issue of restricted securities in the company’s portfolio, it must continuously review the appropriateness of any method so determined.”

¹⁵ ASR 118 at 19988 (“it is incumbent upon the Board of Directors to satisfy themselves that all appropriate factors relevant to the fair value of securities for which market quotations are not readily available have been considered”). *See also* 2014 Money Market Fund Release, *supra* footnote 14, at n.896 (citing ASR 118).

¹⁶ ASR 118.

challenges.¹⁷ Furthermore, advances in communications and technology have greatly enhanced the availability and currency of pricing information.¹⁸ Today there is a greater volume of data available that may bear on determinations of fair value, and new technologies have developed that facilitate enhanced price discovery and greater transparency.¹⁹ Many funds also now engage third-party pricing services to provide pricing information, particularly for thinly traded or more complex assets.²⁰

In addition, three significant regulatory developments since 1970 have fundamentally altered how boards, advisers, independent auditors (also referred to herein as “independent accountants”), and other market participants address valuation for various purposes under the federal securities laws.

¹⁷ See Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers’ Transactions in Certain Leveraged/Inverse Investment Vehicles, Investment Company Act Release No. 33704 (“Derivatives Release”) (Nov. 25, 2019) (noting the dramatic growth in the volume and complexity of the derivatives markets over the past two decades, and the increased use of derivatives by certain funds); Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776 (Aug. 31, 2011) at 69 (noting that “[v]aluation of some derivatives may present special challenges for funds”).

The fund industry has grown tremendously in the intervening years. For example, in December 1969, open-end funds had net assets of over \$53 billion. See H.R. Rep. No. 1382, 91st Cong., 2d Sess. 2 (1970). As of August 31, 2019, there were 12,040 open-end funds registered with the Commission with total net assets of nearly \$28 trillion. (We estimate the number of registered investment companies and their net assets by reviewing all Forms N-CEN filed with the Commission between June 2018 and August 2019.) Moreover, as of June 2019, there were 99 BDCs with \$63 billion in total net assets. (Estimates of the number of BDCs and their net assets are based on a staff analysis of Form 10-K and Form 10-Q filings as of June 30, 2019.) BDCs, which did not exist in 1970, must invest at least 70% of their assets in certain investments that may be difficult to value. See Section 55(a) of the Act.

¹⁸ For example, FINRA’s TRACE introduced in 2002 is an over-the-counter real-time price dissemination service for the fixed income market. See https://www.finra.org/sites/default/files/TRACE_Overview.pdf

¹⁹ For example, the Electronic Municipal Market Access (“EMMA”) website, available since 2009, “provides free public access to objective municipal market information and interactive tools for investors, municipal entities and others.” See <https://emma.msrb.org/#>.

²⁰ 2014 Money Market Fund Release, *supra* footnote 14 (“many funds . . . use evaluated prices provided by third-party pricing services to assist them in determining the fair values of their portfolio securities”).

The first such development was the enactment of the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”) and the adoption of rules mandated by the Sarbanes-Oxley Act.²¹ In particular, the Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (“PCAOB”). The PCAOB oversees the audits of companies that are subject to the federal securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.²² The PCAOB also has the authority to establish or adopt, among other things, professional standards, including audit and quality controls standards, to be used by registered public accounting firms in the preparation and issuance of audit reports.²³ In addition, section 108 of the Sarbanes-Oxley Act established criteria necessary for the work product of an accounting standard-setting body to be recognized as “generally accepted” for purposes of the federal securities laws.²⁴ Rule 30a-3 under the Investment Company Act, which was adopted in part to implement certain

²¹ Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745.

²² *See* Sarbanes-Oxley Act, *supra* footnote 21, at Title I Sec. 101(a).

PCAOB auditing standards apply to the preparation or issuance of “audit reports,” which are defined to include documents, reports, notices, or other records that, among other things, are prepared following an audit performed for purposes of compliance by an issuer, broker, or dealer with the requirements of the securities laws. *See* PCAOB rule 3200; PCAOB rule 1001(a)(vi). *See also* PCAOB rule 1001(i)(iii) (defining the term “issuer” to include issuers (as defined in Section 3 of the Securities Exchange Act of 1934 (the “Exchange Act”)), the securities of which are registered under Section 12 of the Exchange Act, or that are required to file reports under the Exchange Act or that file or have filed registration statements that have not yet become effective under the Securities Act of 1933 (the “Securities Act”), and that have not been withdrawn).

²³ *See* Sarbanes-Oxley Act, *supra* footnote 21, at Title I Sec. 101(c)(2).

²⁴ The federal securities laws for this purpose are the Securities Act, the Exchange Act, the Sarbanes-Oxley Act, the Trust Indenture Act of 1939, the Investment Company Act, the Advisers Act, and the Securities Investor Protection Act of 1970, and the rules, regulations and Commission orders thereunder. *See* PCAOB rule 1001(s)(ii); section 3(a)(47) of the Exchange Act.

requirements of the Sarbanes-Oxley Act, requires registered management investment companies to maintain disclosure controls and procedures and internal control over financial reporting.²⁵

Second was the adoption in 2003 of compliance rules under the Investment Company Act and the Advisers Act (together, the “Compliance Rules”).²⁶ The Compliance Rules were designed to enhance compliance with the federal securities laws by requiring funds and advisers to adopt and implement written compliance policies and procedures that are reasonably designed to prevent violation of the federal securities laws, to review those policies and procedures annually for their adequacy and the effectiveness of their implementation, and to designate a chief compliance officer (“CCO”) to be responsible for administering them.²⁷ Of particular relevance, the Commission stated that rule 38a-1 requires a fund to adopt compliance policies and procedures with respect to fair value that require the fund to:

1. monitor for circumstances that may necessitate the use of fair value;

²⁵ The Commission adopted rule 30a-3 and a number of other rules in order to implement certain certification requirements of the Sarbanes-Oxley Act, *supra* footnote 21, that are applicable to companies filing reports under section 13(a) or 15(d) of the Exchange Act, and to extend those requirements to all registered management investment companies other than small business investment companies registered on Form N-5. *See* Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act, Investment Company Act Release No. 25914 (Jan. 27, 2003) (adopting Investment Company Act rule 30a-3); Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Investment Company Act Release No. 26068 (June 5, 2003) (amending rule 30a-3). *See also* Certification of Disclosure in Companies’ Quarterly and Annual Reports, Investment Company Act Release No. 25722 (Aug. 30, 2002) (adopting Exchange Act rules 13a-15 and 15d-15 to require that certain Exchange Act filers have disclosure controls and procedures in order “to assist principal executive and financial officers in the discharge of their responsibilities in making the required certifications, as well as to discharge their responsibilities in providing accurate and complete information to security holders”).

²⁶ 17 CFR 270.38a-1 and 17 CFR 275.206(4)-7. *See also* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) (“Compliance Rules Adopting Release”).

²⁷ Investment Company Act rule 38a-1 provides that the policies and procedures must be reasonably designed to prevent violations of the federal securities laws (as defined in the rule), and Advisers Act rule 206(4)-7 provides that the policies and procedures must be reasonably designed to prevent violations of the Advisers Act and the rules thereunder.

2. establish criteria for determining when market quotations are no longer reliable for a particular portfolio security;
3. provide a methodology or methodologies by which the fund determines fair value; and
4. regularly review the appropriateness and accuracy of the methodology used to determine fair value, and make any necessary adjustments.²⁸

Third was the issuance and codification by the Financial Accounting Standards Board (“FASB”) of ASC Topic 820 in 2006 and 2009.²⁹ ASC Topic 820 defines the term “fair value” for purposes of the accounting standards³⁰ and establishes a framework for the recognition, measurement, and disclosure of fair value under U.S. generally-accepted accounting principles (“U.S. GAAP”).³¹

Taken together, we believe these regulatory developments have significantly altered the framework in which funds, boards, fund investment advisers, other fund service providers such as pricing services, and auditors perform various functions relating to fair value determinations. We believe that today determining fair value often requires greater resources and expertise than when the Commission issued ASR 113 and ASR 118 roughly fifty years ago. In addition, we believe that regulatory changes during that period have altered the way that boards, fund

²⁸ Compliance Rules Adopting Release, *supra* footnote 26, at section II.A.2.c.

²⁹ The FASB issued *Fair Value Measurements*, Statement of Financial Accounting Standards No. 157 (“SFAS No. 157”), in September 2006, and codified it in 2009 as ASC Topic 820.

³⁰ *See supra* footnote 13 (describing the difference between what “fair value” means under the Investment Company Act and under ASC Topic 820).

³¹ *Id.* Rule 4-01(a)(1) of Regulation S-X [17 CFR 210.4-01(a)(1)] states that “[f]inancial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided.”

investment advisers, other fund service providers, and auditors address valuation. Our views are also informed by significant outreach that the staff has conducted with funds, investment advisers, audit firms, trade groups, fund directors, and others, particularly over the past two years. As part of these discussions, many boards sought additional clarity on how they can effectively fulfill their fair value determination obligations while seeking the assistance of others. The staff understands that this is of particular focus in light of the increased complexity of many fund portfolios and the in-depth expertise required to accurately fair value such complex investments.

In recognition of these changes, we are proposing a new rule to reflect the increased role that subsequent accounting and auditing developments play in setting fund fair value practices, as well as the growing complexity of valuation and the interplay of the compliance rule in facilitating board oversight of funds. The proposed rule also acknowledges the important role that fund investment advisers now play and expertise they now provide in the fair value determination process given these and other developments.

II. DISCUSSION

The proposed rule would provide requirements for determining fair value in good faith with respect to a fund for purposes of section 2(a)(41) of the Act and rule 2a-4 thereunder.³² We believe that, in light of the developments discussed above, to determine the fair value of fund investments in good faith requires a certain minimum, consistent framework for fair value and standard of baseline practices across funds, which would be established by the proposed rule.

³² The rule would define “fund” as a registered investment company or a business development company. Proposed rule 2a-5(e)(1).

The proposed rule would also permit a fund’s board to assign fair value determinations to an investment adviser of the fund.³³ Permitting a fund’s board to assign fair value determinations to an investment adviser is designed to recognize the developments discussed above, including the important role that fund investment advisers now play and expertise they now provide in the fair value determination process, given these developments. However, when a fund’s board uses the services of a fund investment adviser as part of the fair value determination process, we believe it is particularly important to establish a framework for boards to effectively oversee the investment adviser through the proposed rule, in light of the adviser’s conflicts of interest and given that, in these circumstances, the fund’s board would satisfy its statutory obligation to determine fair value in good faith through the framework of the proposed rule, including this board oversight.

Accordingly, under the proposed rule, fair value as determined in good faith would require assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; overseeing and evaluating any pricing services used; adopting and implementing policies and procedures; and maintaining certain records.³⁴ These required functions generally reflect our understanding of current practices used by funds to fair value their investments and we discuss each in detail below. When a board assigns the determination of fair value to an adviser for some or all of the fund’s investments under the proposed rule, in addition to board oversight, the rule would include certain reporting,

³³ For purpose of the proposed rule, “board” means either the fund’s entire board of directors or a designated committee of such board composed of a majority of directors who are not interested persons of the fund. Proposed rule 2a-5(e)(3).

³⁴ Proposed rule 2a-5(a).

recordkeeping, and other requirements designed to facilitate the board's oversight of the adviser's fair value determinations.³⁵

The proposed rule would apply to all registered investment companies and BDCs, regardless of their classification or sub-classification (*e.g.*, open-end funds and closed-end funds, including BDCs³⁶), or their investment objectives or strategies (*e.g.*, equity or fixed income; actively managed or tracking an index).³⁷ In the case of a unit investment trust ("UIT"), because a UIT does not have a board of directors or investment adviser, a UIT's trustee would conduct fair value determinations under the proposed rule.³⁸

We are also proposing to rescind ASR 113 and 118, which provide guidance on, among other things, the role of the fund board in fair value determinations as well as guidance on certain accounting and auditing matters. In addition, the staff letters related to the board role in the fair value process would be withdrawn as discussed in section II.E below.³⁹

³⁵ Proposed rule 2a-5(b).

³⁶ An open-end fund is a management investment company that offers for sale or has outstanding redeemable securities of which it is the issuer. *See* section 5(a)(1) of the Investment Company Act. A closed-end fund is a management investment company other than an open-end fund. *See* section 5(a)(2) of the Investment Company Act. Section 2(a)(48) of the Investment Company Act defines a "business development company" as any closed-end investment company that operates for the purpose of making investments in securities described in section 55(a)(1) through 55(a)(3) of the Investment Company Act and that makes available significant managerial assistance with respect to the issuers of such securities.

³⁷ *See* proposed rule 2a-5(e)(1) (defining "fund" to mean a registered investment company or business development company).

³⁸ Proposed rule 2a-5(d). Section 4(2) of the Investment Company Act defines a UIT as an investment company that (1) is organized under a trust indenture or similar instrument, (2) does not have a board of directors, and (3) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities. *But see* Form N-7 for Registration of Unit Investment Trusts under the Securities Act of 1933 and the Investment Company Act of 1940, Investment Company Act Release No. 15612, Appendix B, Guide 2, [52 FR 8268, 8295-96 (Mar. 17, 1987)] (Staff Guidelines stating that the board's fair value role under section 2(a)(41) is to be performed by the UIT's trustee or the trustee's appointed person). *See infra* section II.D (rescission of staff guidance).

³⁹ The staff's review will include, but will not necessarily be limited to, the letters identified in that section.

A. Fair Value as Determined in Good Faith Under Section 2(a)(41) of the Act

We discuss below each of the required functions set forth in proposed rule 2a-5(a) that must be performed to determine in good faith the fair value of the fund's investments.⁴⁰

1. Valuation Risks

Proposed rule 2a-5 would provide that determining fair value in good faith requires periodically assessing any material risks associated with the determination of the fair value of the fund's investments, including material conflicts of interest, and managing those identified valuation risks.⁴¹ We believe that assessing and managing identified valuation risks is an important element for determining fair value in good faith because ineffectively managed valuation risks can make it more likely that a board or an adviser may incorrectly value an investment.

There are many potential sources of valuation risk. A non-exhaustive list of the types or sources of valuation risk includes:

- the types of investments held or intended to be held by the fund;
- potential market or sector shocks or dislocations;⁴²
- the extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the adviser;⁴³

⁴⁰ These requirements would apply to a fund's board that is determining fair value or, if the board assigns any fair value determinations to an adviser as discussed below, to that adviser.

⁴¹ Proposed rule 2a-5(a)(1). Valuation risk includes the risks associated with the process of determining whether an investment must be fair valued in the first place.

⁴² Potential indicators of market or sector shocks or dislocations could include a significant change in short-term volatility or market liquidity, significant changes in trading volume, or a sudden increase in trading suspensions.

⁴³ See *infra* footnotes 209–210 and accompanying text.

- the proportion of the fund’s investments that are fair valued as determined in good faith, and their contribution to the fund’s returns;
- reliance on service providers that have more limited expertise in relevant asset classes; the use of fair value methodologies that rely on inputs from third party service providers; and the extent to which third party service providers rely on their own service providers (so-called “fourth party” risks); and
- the risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.

Other than material conflicts of interest, the proposed rule does not identify the specific valuation risks to be addressed under this requirement. Rather, we believe that specific valuation risks would depend on the facts and circumstances of a particular fund’s investments. The proposed rule also does not include a specific frequency for the required periodic re-assessment of a fund’s valuation risks, as we believe that different frequencies may be appropriate for different funds or risks. We believe that the periodic re-assessment of valuation risk generally should take into account changes in fund investments, significant changes in a fund’s investment strategy or policies, market events, and other relevant factors.

We request comment on the proposal to require the assessment and management of the material risks associated with fair value determinations.

1. Is this requirement appropriate? Should we further define what risks would need to be considered or provide guidance on the types of valuation risks that a fund may face? Are there additional sources or types of valuation risk that we should address? If so, what sources?

2. Should we require a certain minimum frequency for re-assessing valuation risk (e.g., annually or quarterly)? Should the rule specify types of market events or investment strategy changes that would require a re-assessment of valuation risk? If so, what events or changes should prompt such a review?
3. Should we provide any further guidance on how valuation risk should be managed?

2. *Fair Value Methodologies*

Proposed rule 2a-5 would provide that fair value as determined in good faith requires selecting and applying in a consistent manner an appropriate methodology or methodologies⁴⁴ for determining (which includes calculating) the fair value of fund investments. This requirement would include 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 the fund intends to invest.⁴⁵ The proposed rule also would require the selected methodologies to be periodically reviewed for appropriateness and accuracy, and to be adjusted if necessary. Selecting and applying a methodology consistently—and reviewing the methodology and adjusting it if necessary—are all important elements to determining fair value

⁴⁴ ASC Topic 820 refers to valuation approaches and valuation techniques. In practice, many valuation techniques are referred to as *methods* (e.g., discounted cash flow method). As a result, this release uses the terms “technique” and “method” interchangeably to refer to a specific way of determining fair value and likewise uses the terms “methods” and “methodologies” interchangeably.

⁴⁵ Proposed rule 2a-5(a)(2). Regarding the key inputs and assumptions specific to each asset class or portfolio holding, it would not be sufficient, for example, to simply state that private equity investments are valued using a discounted cash flow model, or that options are valued using a Black-Scholes model, without providing any additional detail on the specific qualitative and quantitative factors to be considered, the sources of the methodology’s inputs and assumptions, and a description of how the calculation is to be performed (which may, but need not necessarily, take the form of a formula).

in good faith.⁴⁶ This is because an inappropriate methodology, or a methodology that is applied inconsistently, increases the likelihood that a fund's investments will be improperly valued.

Currently, ASC Topic 820 refers to valuation approaches, including the market approach, income approach, and cost approach, as well as valuation techniques and methods as ways in which to measure fair value.⁴⁷ To be appropriate under the rule, and in accordance with current accounting standards, a methodology used for purposes of determining fair value must be consistent with ASC Topic 820, and thus derived from one of these approaches. We recognize, however, that there is no single methodology for determining the fair value of an investment because fair value depends on the facts and circumstance of each investment, including the relevant market and market participants.⁴⁸

Proposed rule 2a-5 also would require that the board or adviser consider the applicability of the selected fair value methodologies to types of fund investments that a fund does not currently hold but in which it intends to invest in the future.⁴⁹ This requirement is designed to facilitate the effective determination of the fair value of these new investments by the board or

⁴⁶ Different methodologies may be appropriate for different asset classes. Accordingly, this requirement would not require that a single methodology be applied in all cases, but instead that any methodologies selected be applied consistently to the asset classes for which they are relevant.

⁴⁷ *See supra* footnote 44.

⁴⁸ *See* ASR 118 (“Methods which are in accord with this principle may, for example, be based on a multiple of earnings, or a discount from market of a similar freely traded security, or yield to maturity with respect to debt issues, or a combination of these and other methods.”). Consistent with the principles in ASC Topic 820, under the proposal, the methodologies selected should maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

⁴⁹ Proposed rule 2a-5(a)(2)(i). For example, the board or adviser, as applicable, generally should address, prior to the fund's investing in a new type of investment, whether readily available market quotations will be used or if the investment may need to be fair valued on occasion or at all times. For certain types of investments, it should be clear that the asset will require a fair value at all times. For others, however, market quotations may sometimes be readily available and sometimes not, so that periodically a fair value will need to be determined. The board or adviser generally should seek to identify sources of price inputs before the fund invests in such asset classes, if possible, in addition to determining an appropriate fair value methodology, and generally should document these decisions.

adviser. In addition, the proposed rule would require periodic reviews of the selected fair value methodologies for appropriateness and accuracy, and adjustments to the methodologies where necessary. For example, the results of back-testing or calibration (as discussed below) or a change in circumstances specific to an investment could necessitate adjustments to a fund's fair value methodologies.⁵⁰ As discussed above, while the proposed rule would require that the fair value methodologies be consistently applied to the asset classes for which they are relevant, there can be circumstances where it is appropriate to adjust methodologies if the adjustments would result in a measurement that is equally or more representative of fair value.⁵¹ The proposed rule's requirement to apply fair value methodologies in a consistent manner would not preclude the board or adviser from changing the methodology for an investment in such circumstances.⁵²

The proposed rule also would require the board or adviser to monitor for circumstances that may necessitate the use of fair value as determined in good faith.⁵³ The use of fair value is required when market quotations are not readily available. The rule would require the establishment of criteria for determining when market quotations no longer are reliable, and therefore are not readily available.⁵⁴ For example, if a fund invests in securities that trade in foreign markets, the board or adviser generally should identify and monitor for the kinds of

⁵⁰ Proposed rule 2a-5(a)(2)(ii). ASC Topic 820-10-35-25 provides a non-exhaustive list of events that may warrant a change or an adjustment to a valuation technique, including where (1) new markets develop, (2) new information becomes available, (3) information previously used is no longer available, (4) the valuation technique improves, and (5) market conditions change. Boards or advisers generally should seek to account for such occurrences and consider specifying alternative sources.

⁵¹ See ASC Topic 820-10-35-25.

⁵² Records supporting any such methodology changes would be required to be maintained under the proposed recordkeeping provisions. See proposed Rule 2a-5(a)(6).

⁵³ Proposed rule 2a-5(a)(2)(iii). As discussed below, we are also proposing to define when market quotations are readily available for purposes of section 2(a)(41).

⁵⁴ Proposed rule 2a-5(a)(2)(iv).

significant events that, if they occurred after the market closes in the relevant jurisdiction but before the fund prices its shares, would materially affect the value of the security and therefore may suggest that market quotations are not reliable.⁵⁵

We continue to believe that for any particular investment there may be a range of appropriate values that could reasonably be considered to be fair value, and whether a specific value should be considered fair value will depend on the facts and circumstances of the particular investment. Accordingly, we expect that the methodologies used may reflect this range of potential fair values and result in unbiased determinations of fair value within the range.

We request comment on the proposed requirement to establish and apply the methodologies for determining and calculating fair value.

4. This requirement includes several specified elements, discussed above, relating to the fair value methodologies. Are these elements appropriate? Are there additional elements that commenters believe should be included under this requirement? Should we modify or remove any of the proposed elements? Should we require application of the methodologies in a reasonably consistent manner, or as consistently as possible under the circumstances?
5. Do commenters believe we should provide additional guidance relating to this requirement? If so, on which elements of the proposed requirement should we provide additional guidance? For example, is the proposed requirement that boards or advisers “select” a methodology sufficiently clear?

⁵⁵ See ASC Topic 820-10-35-41C(b).

6. Are there investments for which it is not feasible to establish a methodology in advance? If so, how should the rule address such situations? Is it clear what new investment types a fund may “intend” to invest in? Should we provide any further guidance on this? What processes do funds currently follow before investing in new types of investments to help to ensure that, after making the investment, the board will be in a position to determine fair value if required?

3. *Testing of Fair Value Methodologies*

The proposed rule would require the testing of the appropriateness and accuracy of the methodologies used to calculate fair value.⁵⁶ 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.⁵⁷ We believe that the results of calibration and back-testing can be particularly useful in identifying trends, and also have the potential to assist in identifying issues with methodologies applied by fund service providers, including poor performance or potential conflicts of interest.⁵⁸

⁵⁶ Proposed rule 2a-5(a)(3).

⁵⁷ *Id.* Calibration can assist in assessing whether the fund’s valuation technique reflects current market conditions, and also whether any adjustments to the valuation technique are appropriate. “Calibration” for these purposes is the process for monitoring and evaluating whether there are material differences between the actual price the fund paid to acquire portfolio holdings that received a fair value under the Act and the prices calculated for those holdings by the fund’s fair value methodology at the time of acquisition.

⁵⁸ Back-testing involves a comparison of 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. One

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, however, that back-testing may be less useful for portfolio holdings that trade infrequently.⁵⁹

We request comment on the proposed rule's requirement to test the appropriateness and accuracy of the fair value methodologies.

7. Should the rule require particular testing types or minimum testing frequencies?

For example, should we require tests to occur at least weekly, monthly, or quarterly? If so, should the frequency required be dependent upon the type of instrument? Should the rule require all funds to use certain types of testing, such as back testing and calibration, at a minimum? Are certain types of methodology testing inappropriate or irrelevant for certain investment types?

8. What other types of testing of fair value methodologies are commonly used?
9. Should the rule require specified actions based on the results of the testing? If so, what would those actions be?

4. *Pricing Services*

To obtain valuation information, particularly for thinly traded or more complex assets, pricing services, may be used. Pricing services are third-parties that regularly provide funds with information on evaluated prices, matrix prices, price opinions, or similar pricing estimates or

common form of back-testing is "disposition analysis," which compares a fair value as determined using a fair value technique with the price obtained for the security upon its disposition by the fund.

⁵⁹ See *In re Morgan Asset Management*, *supra* footnote 9 (back-testing by the fund "only covered securities after they were sold; thus, at any given time, the Valuation Committee never knew how many securities' prices could ultimately be validated by it.").

information to assist in determining the fair value of fund investments.⁶⁰ Accordingly, the proposed rule would provide that determining fair value in good faith requires the oversight and evaluation of pricing services, where used.⁶¹ This provision is designed to help ensure that pricing information received from pricing services serves as a reliable input for determining fair value in good faith.

For funds that use pricing services, the proposed rule would require that the board or adviser establish a process for the approval, monitoring, and evaluation of each pricing service provider. The board or adviser generally should take into consideration factors such as (i) the qualifications, experience, and history of the pricing service; (ii) the valuation methods or techniques, inputs, and assumptions⁶² used by the pricing service for different classes of holdings, and how they are affected as market conditions change; (iii) the pricing service's process for considering price "challenges,"⁶³ including how the pricing service incorporates information received from pricing challenges into its pricing information; (iv) the pricing service's potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and (v) the testing processes used by the pricing service.

In addition, there may be times when pricing information from a pricing service differs materially from the board's or adviser's view of the fair value of the investment, and the board or

⁶⁰ See 2014 Money Market Fund Release, *supra* footnote 14, at section III.D.2.b.

⁶¹ Proposed rule 2a-5(a)(4).

⁶² In considering a pricing service's valuation methods or techniques, inputs, and assumptions, the fair value policies and procedures generally should address whether the pricing service is relying on inputs or assumptions provided by the adviser.

⁶³ Price challenges involve, for example, the fund disagreeing with an evaluated price provided by a pricing service and providing additional information to the service suggesting that the provided evaluated price is not correct.

adviser may seek to contact the pricing service to question the basis for the pricing information. As such, the proposed rule would require the establishment of criteria for the circumstances under which price challenges typically would be initiated (*e.g.*, establishing objective thresholds).

We request comment on the proposed rule's requirement to oversee pricing services.

10. Do commenters agree that the proposed rule should require oversight of pricing service providers, if used? Should the rule cover any service providers other than pricing services? If so, which service providers should be included? Should the rule further clarify who qualifies as a pricing service?
11. Should there be a specific requirement in the rule to periodically review the selection of the pricing services used and to evaluate other pricing services?

5. *Fair Value Policies and Procedures*

Proposed rule 2a-5 would require written policies and procedures addressing the determination of the fair value of the fund's investments ("fair value policies and procedures").⁶⁴ The proposed rule would require the fair value policies and procedures to be reasonably designed to achieve compliance with the requirements of proposed rule 2a-5 discussed above. Requiring fair value policies and procedures that would be tailored to the proposed rule's requirements would help to ensure that a board or adviser, as applicable, determines the fair value of fund investments in compliance with the rule. Under the proposed rule, where the board determines the fair value of investments, the board-approved fair value policies and procedures would be adopted and implemented by the fund. Where the board assigns fair value determinations to the

⁶⁴ Proposed rule 2a-5(a)(5).

adviser under proposed rule 2a-5(b), as discussed in section II.B, the fair value policies and procedures would be adopted and implemented by the adviser, subject to board oversight under rule 38a-1.⁶⁵

Rule 38a-1 also would apply to a fund's obligations under the proposed rule. Rule 38a-1 requires a fund's board, including a majority of its independent directors, to approve the fund's policies and procedures, including those on fair value, and those of each investment adviser and other specified service providers, based upon a finding by the board that the policies and procedures are reasonably designed to prevent violation of the federal securities laws.⁶⁶ Rule 38a-1 also requires that the fund's CCO provide an annual report to the fund's board⁶⁷ that must address any material changes to compliance policies and procedures.⁶⁸ Rule 38a-1 would encompass a fund's compliance obligations with respect to proposed rule 2a-5, if adopted, and would require a fund's board to oversee compliance with the rule.⁶⁹ To the extent that adviser policies and procedures under proposed rule 2a-5 would otherwise be duplicative of fund valuation policies under rule 38a-1,⁷⁰ a fund could adopt the rule 2a-5 policies and procedures of the adviser in fulfilling its rule 38a-1 obligations.

⁶⁵ Proposed rule 2a-5(b).

⁶⁶ Rule 38a-1(a)(2).

⁶⁷ For UITs, the fund's principal underwriter or depositor conducts the functions assigned to management company boards under rule 38a-1. Rule 38a-1(b). This would continue if we adopt the proposed rule.

⁶⁸ See rule 38a-1(a)(4)(iii)(A). See also Compliance Rules Adopting Release, *supra* footnote 26, at n.33. "Material" in this context is a change that a fund director would reasonably need to know in order to oversee fund compliance. See rule 38a-1(e)(2). We have also said that "serious compliance issues" must be raised with the board immediately. See Compliance Rules Adopting Release, *supra* footnote 26, at n.33.

⁶⁹ If adopted, rule 2a-5's requirements would supersede the Compliance Rules Adopting Release's discussion of specific policies and procedures required regarding the pricing of portfolio securities and fund shares. Cf. Compliance Rules Adopting Release, *supra* footnote 26, at nn.39-47 and accompanying text.

⁷⁰ See generally footnote 108.

We request comment on the proposed fair value policies and procedures requirement.

12. Are there specific elements that the proposed fair value policies and procedures should include other than the required elements of proposed rule 2a-5(a)?
13. Are we sufficiently clear on the interaction between rule 38a-1 and the policies and procedures under proposed rule 2a-5? Should we provide any further guidance on their interaction?

6. *Recordkeeping*

Proposed rule 2a-5 would require that the fund maintain certain records.⁷¹ Specifically, the proposed rule would require the maintenance of:

- *Supporting Documentation.* 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, for at least five years from the time the determination was made, the first two years in an easily accessible place; and
- *Policies and Procedures.* 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, in an easily accessible place.

Funds and advisers currently are required to retain certain documentation related to fund valuation.⁷² Documents often provide the primary means to demonstrate whether portfolio

⁷¹ Proposed rule 2a-5(a)(6). Under the proposed rule, the fund would maintain the required records both where the board itself determines the fair value of investments and where it assigns fair value determinations to an adviser under proposed rule 2a-5(b), as discussed at *infra* section II.B.6.

holdings have been valued in a manner consistent with applicable law, any valuation compliance policies and procedures, and any disclosures. They also provide evidence to the fund's auditors in performing their duties related to the audit of the fund's financial statements and assist the fund's CCO in the preparation of compliance reports to the board. The Commission has brought enforcement actions in cases where it alleged that appropriate documentation relating to valuation was not maintained by a fund or adviser or obtained by auditors.⁷³

The proposed requirement to maintain appropriate documentation to support fair value determinations would include documentation that would be sufficient for a third party to verify the fair value determination. We understand that advisory personnel currently produce working papers supporting fair value determinations that include, for example, calibration and back-

⁷² Rule 38a-1(d) requires the maintenance of certain records, including copies of: all compliance policies and procedures adopted by the fund that are in effect or were in effect at any time during the last five years; materials provided to the board in connection with their approval of fund and service provider policies and procedures under the rule; the CCO's annual report to the board; and any records documenting the board's annual review of fund and service provider compliance policies and procedures under the rule. Rule 204-2 under the Advisers Act similarly requires an adviser to maintain copies of the adviser's compliance policies and procedures that are in effect or were in effect at any time during the last five years and any records documenting its annual review of such policies and procedures. *See* 17 CFR 275.204-2. *See also* Compliance Rules Adopting Release, *supra* footnote 26, at section II.D. The funds' and advisers' records may be retained electronically. *See id.* (discussing rule 31a-2(f) under the Investment Company Act and rule 204-2(g) under the Advisers Act).

Other provisions of the federal securities laws require, among other things, that registered investment companies maintain appropriate books and records in support of the fund's financial statements and preserve for a specified period (generally six years) all schedules evidencing and supporting each computation of NAV. *See* Investment Company Act section 31(a) and rules 31a-1 and 31a-2. In addition, funds reporting under the Exchange Act must make and keep books, records, and accounts that accurately and fairly reflect their transactions and dispositions of their assets in reasonable detail. 15 U.S.C. 78m(b)(2)(A).

⁷³ *See* In re Allied Capital Corp., Securities Exchange Act Release No. 55931 (June 20, 2007) (settlement) (fund failed to maintain documentation required under the Exchange Act). *See also* In the Matter of Carroll A. Wallace, Securities Exchange Act Release No. 48372 (Aug. 20, 2003) (Commission opinion) (partner of accounting firm engaged in improper professional conduct in recklessly failing to obtain sufficient competent evidential material to support statements in the auditors' reports); In the Matter of Morgan Stanley, Securities Exchange Act Release No. 50632 (Nov. 4, 2004) (settlement) (financial services firm failed to maintain sufficient underlying documentation supporting certain valuations).

testing data as well as other information such as stale price analysis.⁷⁴ These records would be required to be maintained as supporting fair value determinations.⁷⁵

We believe that it is appropriate for the proposed rule to include a recordkeeping provision to facilitate compliance with the proposed rule and to permit effective regulatory oversight. The proposed retention periods are designed to be consistent with the recordkeeping requirements in rule 38a-1(d), the compliance rule. As discussed above, the compliance rule requires the retention of, among other things, compliance policies and procedures (which would include those relating to valuation) and certain records.⁷⁶ We believe that this recordkeeping requirement would provide important investor protections and, because it would be consistent with current record retention practices under to rule 38a-1(d), would not impose overly burdensome recordkeeping costs.

We request comment on the proposed recordkeeping provisions.

14. Are there any additional types of records that we should require? If so, which records and why?
15. Where the board assigns fair value determinations to an adviser under proposed rule 2a-5(b), should the rule require the adviser, rather than the fund, to maintain these records?

⁷⁴ Stale price analysis can include an evaluation of whether a price quote that may be used to support a fair value price is sufficiently timely to be useful.

⁷⁵ Proposed rule 2a-5(a)(6)(i).

⁷⁶ *See supra* footnote 72.

16. Are the proposed retention periods sufficient to evidence compliance? Why or why not? Should we require a longer (*e.g.*, six years) or shorter (*e.g.*, four years) retention period?
17. Are key terms used in this aspect of the proposal sufficiently understandable? For example, as stated above, “appropriate documentation to support fair value determinations” under the proposed recordkeeping requirement would include documentation that would be sufficient for a third party to verify the fair value determination. Should we define these or other terms or provide further guidance relating to them?

B. Performance of Fair Value Determinations

The Act assigns boards a critical role in connection with determinations of fair value.⁷⁷

Although the Commission has previously taken the position that a fund’s board may not delegate the determination of fair value to anyone else,⁷⁸ the Commission has also recognized that compliance with the Act does not require the board to perform each of the specific tasks required

⁷⁷ Section 2(a)(41)(B)(ii) provides that, when market quotations are not readily available, “value” means “fair value as determined in good faith by the board of directors.” Rule 2a-4 contains the same definition of fair value as section 2(a)(41)(B)(ii). 17 CFR 270.2a-4. The Commission has discussed the board’s role in determinations of fair value in a number of Commission releases, including ASR 113, ASR 118, the Compliance Rules Adopting Release, *supra* footnote 26, and the 2014 Money Market Fund Release, *supra* footnote 14.

In addition to their role under the Act, boards may have liability under antifraud provisions of the federal securities laws if a fund’s prospectus or other disclosures regarding valuation are not consistent with the fund’s valuation practices. *See, e.g.*, 15 U.S.C. 77k(a)(1).

⁷⁸ *See, e.g.*, 2014 Money Market Fund Release, *supra* footnote 14, at nn.890 and 896 and accompanying text; In the Matter of Seaboard Associates, Inc. (Report of Investigation Pursuant to Section 21(a) of the Exchange Act), Investment Company Act Release No. 13890 (Apr. 16, 1984) (“The Commission wishes to emphasize that the directors of a registered investment company may not delegate to others the ultimate responsibility of determining the fair value of any asset not having a readily ascertainable market value, such as oil and gas royalty interests.”).

to calculate fair value itself.⁷⁹ We believe that the Commission’s prior guidance recognized that determinations of fair value often require significant resources and specialized expertise, and that in many cases it may be impracticable for directors themselves to perform every one of the necessary tasks without assistance. We expect that today determining fair value requires even greater resources and expertise than when ASR 113 and ASR 118 were issued. For this reason, in addition to providing requirements for determining fair value in good faith generally, the proposed rule also is designed to provide boards and advisers with a consistent, modern approach to the allocation of fair value functions, while also preserving a crucial role for boards to fulfill their obligations under section 2(a)(41) of the Act.

Under the proposed rule, a board may choose to determine fair value in good faith for any or all fund investments by carrying out all of the functions required in paragraph (a) of the proposed rule, including, among other things, monitoring for circumstances that necessitate fair value, selecting valuation methodologies, and applying those methodologies.⁸⁰ However, a board would not be required to take this approach. We understand that, for practical reasons, few boards today are directly involved in the performance of the day-to-day valuation tasks

⁷⁹ The Commission stated in ASR 118 that the board “may appoint persons to assist them in the determination of [fair] value, and to make the actual calculations pursuant to the board’s direction”; however, “the findings of such individuals must be carefully reviewed by the directors in order to satisfy themselves that the resulting valuations are fair.” *See also* ASR 113 (“The actual calculations may be made by persons acting pursuant to the direction of the board.”).

⁸⁰ As discussed above, in this circumstance, the fund would, on behalf of the board, adopt and implement policies and procedures and keep records consistent with the requirements of paragraph (a) of the proposed rule. *See* proposed rule 2a-5(b).

required to determine fair value. Instead they enlist the fund's investment adviser to perform certain of these functions, subject to their supervision and oversight.⁸¹

This allocation of functions is consistent with the framework created by the ASRs. We continue to believe that allocating day-to-day responsibilities to an investment adviser, subject to robust board oversight, is appropriate and consistent with the requirements of Act. The proposed rule is designed to provide a consistent framework for this allocation between boards and advisers, and to provide enhanced protections which we believe are consistent with the more modern approaches to fair value and compliance with the federal securities laws described below.

Accordingly, the proposed rule would permit a fund's board of directors to assign the fair value determination relating to any or all fund investments to an investment adviser of the fund, which would carry out all of the functions required in paragraph (a) of the proposed rule, subject to certain requirements enumerated in proposed paragraph (b).⁸² A fund's board could make this assignment to a fund's primary adviser or one or more sub-advisers. For example, for a fund with a sub-adviser responsible for managing a portion of the fund's portfolio, the board could assign the determination of fair value for the investments in that portion of the fund's portfolio to that sub-adviser. As a result, a multi-manager fund could have multiple advisers assigned the role of determining fair value of the different investments that those advisers manage. Where the

⁸¹ For example, for a fund that issues redeemable securities, value must be calculated at least once each business day for each portfolio holding in order to calculate the fund's NAV. 17 CFR 270.22c-1(b)(1). Making these fair value determinations by themselves would therefore likely be impracticable for most, if not all, boards of such funds.

⁸² As noted above, because a UIT does not have a board of directors or an investment adviser, a UIT's trustee would conduct fair value determinations under the proposed rule. *See* proposed rule 2a-5(d). *See also supra* footnote 38.

board assigns fair value determinations to multiple advisers, the fund's policies and procedures adopted under rule 38a-1 should address the added complexities of overseeing multiple assigned advisers in order to be reasonably designed to avoid violating the federal securities laws.⁸³ Any board assignment under the proposed rule would be subject to board oversight and certain reporting, recordkeeping, and other requirements designed to facilitate the board's ability effectively to oversee the adviser's fair value determinations. We discuss each of these requirements below.

We request comment generally on the role of the board of directors when it does not assign the fair value determination to an adviser to the fund.

18. For boards that elect to conduct fair value determinations themselves, should we provide any guidance on the level of assistance they can receive from service providers, while fulfilling their obligations under section 2(a)(41)? Do we need to provide any guidance on how a board should obtain and oversee such assistance if needed? If so, what guidance should we provide?

1. *Board Oversight*

Where the 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. Boards should approach their oversight of fair value determinations assigned to an investment adviser of the fund with a skeptical and objective view that takes account of the fund's particular valuation risks, including with respect to conflicts, the

⁸³ See rule 38a-1. These challenges include, for example, how to address reconciling differing opinions on the same investment (if applicable) and establishing clear reporting structures.

appropriateness of the fair value determination process, and the skill and resources devoted to it.⁸⁴ Further, in our view effective oversight cannot be a passive activity. Directors should ask questions and seek relevant information. The board should view oversight as an iterative process and seek to identify potential issues and opportunities to improve the fund's fair value processes.⁸⁵ The proposed rule would require the adviser to report to the board with respect to matters related to the adviser's fair value process, in part to ensure that the board has sufficient information to conduct this oversight.⁸⁶ Boards should also request follow up information when appropriate and take reasonable steps to see that matters identified are addressed.⁸⁷

We would expect that boards engaged in this process would 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. For example, a board's scrutiny would likely be different if a fund invests in publicly traded foreign companies than if the fund invests in private early stage companies. As the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, we expect that the board's level of scrutiny would increase correspondingly.⁸⁸

We also believe that, consistent with their obligations under the Act and as fiduciaries, boards should seek to identify potential conflicts of interest, monitor such conflicts, and take

⁸⁴ See generally Investment Company Governance, Investment Company Act Release No. 26520 (July 27, 2004) ("Governance Release").

⁸⁵ See, e.g., Derivatives Release, *supra* footnote 17, at section II.C.

⁸⁶ Proposed rule 2a-5(b)(1).

⁸⁷ For example, we have stated that independent 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 interest." See Governance Release, *supra* footnote 84.

⁸⁸ For a discussion of fund fair value risks generally, see *supra* section II.A.1.

reasonable steps to manage such conflicts.⁸⁹ In so doing, the board should serve as a meaningful check on the conflicts of interest of the adviser and other service providers involved in the determination of fair values.⁹⁰ In particular, the fund's adviser may have an incentive to improperly value fund assets in order to increase fees, improve or smooth reported returns, or comply with the fund's investment policies and restrictions.⁹¹ 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) or may otherwise be subject to pressures to provide pricing estimates that are favorable to the adviser.⁹² 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.

⁸⁹ See, e.g., Governance Release, *supra* footnote 87 (“...state law duties of loyalty and care... oblige directors to act in the best interest of the fund when considering important matters the Act entrusts to them, such as approval of an advisory contract and the advisory fee.”).

⁹⁰ See, e.g., *id.* (“... the Act and our rules rely heavily on fund boards of directors to manage the conflicts of interest that advisers have with funds they manage.”). See also Division of Investment Management, SEC, Protecting Investors: A Half Century of Investment Company Regulation, 252 (1992) (“the [Investment Company] Act . . . imposes requirements that assume the standard equipment of a corporate democracy: a board of directors . . . whose function is to oversee the operations of the investment company and police conflicts of interest... [W]e believe that independent directors perform best when required to exercise their judgment in conflict of interest situations”); see also Investment Company Institute Independent Directors Council, Fair Valuation Series: The Role of the Board at 10 (2006) (“IDC Role of the Board”), available at http://www.ici.org/pdf/06_fair_valuation_board.pdf (“Investment professionals, for example, can be important sources of information about the value of securities. At the same time, conflict of interest concerns may be raised when investment professionals assign fair valuations that dramatically boost a fund's performance. These concerns may be heightened when the compensation of the investment professionals is based on the fund's performance. To address these potential concerns, boards may want to consider whether investment professionals responsible for managing a particular fund should have sole or primary authority for determining securities valuations for that fund.”).

⁹¹ See, e.g., Piper, *supra* footnote 7. For conflicts of the fund's portfolio manager, see *infra* footnote 120 and accompanying text.

⁹² Cf. *In re Morgan Asset Management*, *supra* footnote 9, at 7 (broker-dealer “induced to provide interim price confirmations that were lower than the values at which the Funds were valuing certain bonds, but higher than the initial confirmations that the [broker-dealer] had intended to provide”).

Boards should probe the appropriateness of the adviser's fair value processes. In particular, boards should periodically review the financial resources, technology, staff, and expertise of the assigned adviser, and the reasonableness of the adviser's reliance on other fund service providers, relating to valuation.⁹³ In addition, boards should consider the adviser's compliance capabilities that support the fund's fair value processes, and the oversight and financial resources made available to the CCO relating to fair value.

Boards should also consider the type, content, and frequency of the reports they receive. The proposed rule would require reporting to the board (both periodically and promptly) regarding many aspects of the adviser's fair value determination process as a means of facilitating the board's oversight as discussed below. While a board can reasonably rely on the information provided to it in summaries and other materials provided by the adviser and other service providers in conducting its oversight, it is incumbent on the board to request and review such information as may be necessary to be fully informed of the adviser's process for determining the fair value of fund investments. Further, if the board becomes aware of material matters (whether the board identifies the matter itself or the fund's CCO or adviser or another party identifies the issue), we believe that in fulfilling its oversight duty the board must inquire about such matters and take reasonable steps to see that they are addressed.⁹⁴

We request comment on this aspect of the proposal:

⁹³ See *In re Morgan Asset Management*, *supra* footnote 9 (“the Valuation Committee left pricing decisions to lower level employees in Fund Accounting who did not have the training or qualifications to make fair value pricing determinations”).

⁹⁴ Proposed rule 2a-5(b)(1)(ii).

19. Should we permit boards to fulfill the statutory function to fair value one or more fund investments in good faith by assigning that fair value determination to an adviser to the fund as described above? Would the proposed rule change the services provided by advisers with respect to valuation and, if so, would such a change have any implications for the board's consideration of the advisory contract under section 15(c) of the Act (*e.g.*, changes in compensation)? If so, are there additional responsibilities under the proposed rule for which advisers would seek additional compensation?
20. The rule would permit boards to assign the determination of fair value only to an adviser to the fund. Are there other parties to which we should permit boards to assign such determinations? For example, would it be appropriate to allow boards to assign these determinations to pricing vendors or accounting firms? Are there any parties that fund boards currently rely upon to help make fair value determinations that could adequately be relied upon in the same way as a fund adviser? If we do permit other parties to be assigned the determination of fair value under the final rule, what safeguards, if any, should we include to ensure that the determinations of fair value in good faith are conducted consistent with the proposed rule? For example, should we only permit assignment to non-advisers if they have a fiduciary duty to the fund or if they are regulated by the Commission? Why or why not?
21. As proposed, the rule would require that an assignment to an investment adviser cover all elements of paragraph (a) for a given investment or investments. Should we permit the assignment of particular elements of paragraph (a) to an investment

adviser or different advisers? If so, what safeguards should we include to ensure that the determinations of fair value in good faith are conducted consistent with the proposed rule?

22. The proposed rule would permit boards to assign the determination of fair value in good faith to the fund's primary investment adviser or one or more sub-advisers. Should we allow boards to assign this process to sub-advisers, or only allow the fund's primary investment adviser to fulfill this role? Why or why not? Should we impose any obligations for the adviser to oversee any assigned sub-adviser? If so, what obligations? For example, should we require in the rule that a fund must establish reconciliation procedures to address situations where sub-advisers have differing views on the fair value of a fund investment?
23. Should we limit the assignment to a single adviser in order to minimize the issues relating to having multiple advisers assigned determinations of fair value under the Act? If so, why? Conversely, should we require additional safeguards in the case of multiple assigned advisers? If so, what should they be? For example, should we require specific policies and procedures or reports, beyond those already required, or those that would be required, under rule 38a-1 or the proposed rule?
24. Should we permit or require anyone other than the trustee of a UIT to perform the functions described in paragraph (a), such as a person appointed by the trustee? Should we, for example, allow the trustee to assign these determinations to the UIT's sponsor, principal underwriter, or depositor? Would these or any other parties be better equipped to determine the fair value of investments? If the rule

were to permit the trustee to assign these determinations to another person, should we require that person to report to the trustee like the adviser would to a board for management companies? What kind of oversight responsibilities should the trustee have? Are there other modifications to the proposed rule that we should make to apply it to UITs given their unmanaged nature and different governance structure compared to other funds?

25. Is our proposed requirement that a board “oversee” the adviser sufficient? Should we prescribe in rule 2a-5 additional steps to mitigate the risk of conflicts of interest and other issues related to the fair value process, such as a third party review of the fair value process, or an attestation by the adviser? If so, what should those steps be? What additional costs would they add, and who would bear those costs?
26. As noted above,⁹⁵ the proposed rule would define “board” as either the fund’s entire board of directors or a designated committee of such board composed of a majority of directors who are not interested persons of the fund.⁹⁶ Are there any actions required in the proposed rule that we should require the full board, rather than a committee, to perform?
27. Would boards assign the fair value determination to an investment adviser with respect to some investments and determine the fair value of other investments themselves? If so, what types of investments would boards most likely assign to

⁹⁵ See *supra* footnote 33.

⁹⁶ Proposed rule 2a-5(e)(3).

an adviser and under what circumstances, and which would they fair value themselves? Should we provide any additional guidance as to how boards would determine the fair value of fund investments where the board does not assign those determinations to an adviser?

2. *Board Reporting*

Effective information flow is a critical part of a board's oversight of an adviser to whom it has assigned fair value determinations. We understand that boards currently receive a variety of reports from the adviser outlining the operation of the fund's valuation process.⁹⁷ While some of the reports currently provided may be useful for boards, others may contain detailed trade-by-trade information, or other day-to-day operational data that may not be effective in facilitating the board's oversight. We believe that it is important for the board to receive relevant and tailored information from the adviser to ensure that the board has sufficient insight and data to exercise the oversight contemplated by the proposed rule. We also believe that these reports should familiarize directors with the salient features of the adviser's process and provide them with an understanding of how that process addresses the requirements of rule 2a-5. Therefore we are proposing the board reporting requirements discussed below.⁹⁸ These requirements are intended to help ensure that boards receive the amount and type of information that they find most valuable in overseeing the adviser.⁹⁹

⁹⁷ See "Practical Guidance for Fund Directors on Valuation Oversight," Report of the Mutual Fund Directors Forum (June 2012) (available at <https://mfdf.org/images/Newsroom/Valuation-web.pdf>) ("MFDF Valuation Report") at 14-15.

⁹⁸ This would be in addition to any reports required under rule 38a-1. See Compliance Rules Adopting Release, *supra* footnote 26, at section II.A.2.c.

⁹⁹ The requirements we propose in this document would be minimum requirements and fund boards could always ask for additional reporting from advisers. See *infra* footnote 110 and accompanying text.

The proposed rule would require the adviser's reports to include such information as may be reasonably necessary for the board to evaluate the matters covered in the reports.¹⁰⁰ This requirement is designed to provide the fund's board with sufficient context for the matters covered in the report. This context is necessary in order to facilitate the board's oversight by providing them with enough information to determine whether to ask additional questions or request additional information, as appropriate. For example, we do not believe that it would be consistent with the proposed rule for the adviser to report that there is a new material conflict of interest without the context necessary for the board to evaluate what effect the conflict would have on the adequacy and effectiveness of the adviser's process for determining fair value. The content of the periodic or prompt reports and supplemental information under the proposal could take the form of narrative summaries, graphical representations, statistical analyses, dashboards, or exceptions-based reporting, among other methods.

a. Periodic Reporting

Proposed rule 2a-5 would require the adviser, at least quarterly, to provide the board a written assessment of the adequacy and effectiveness of the adviser's process for determining the fair value of the assigned portfolio of investments.¹⁰¹ We understand that the materials currently prepared for boards for purposes of board meetings can include detailed information regarding the fair value process, including a list of each individual portfolio holding that received a fair

¹⁰⁰ Proposed rule 2a-5(b)(1). This is similar to the approach we have adopted with regard to money market stress testing and proposed with regard to board oversight of derivatives risk managers. *See* 2014 Money Market Fund Release, *supra* footnote 14, and Derivatives Release, *supra* footnote 17.

¹⁰¹ Proposed rule 2a-5(b)(1)(i).

value since the prior board meeting (*e.g.*, during the quarter).¹⁰² Although some boards may find this specific information useful, we are not proposing to mandate this level of detailed reporting because we believe that the board's oversight may be better facilitated through the use of more targeted forms of reporting designed to identify trends, exceptions, or outliers, and generally provide a sufficient overview of the current state of the fair value process.¹⁰³ Accordingly, the proposed rule would require the adviser's periodic reports to provide the adviser's evaluation of the adequacy and effectiveness of its process for determining fair value. The periodic reports would be required to, at a minimum, include a summary or description of the following information:

- *Material Valuation Risks.* The assessment and management of material valuation risks that would be required under the proposed rule. This would include any material conflicts of interest of the investment adviser and any other service provider.¹⁰⁴ As discussed above, we believe that assessing and managing identified valuation risks is an important element for determining fair value in good faith because valuation risks that are not effectively managed can make it more likely that the adviser has incorrectly valued an investment.
- *Material Changes to or Material Deviations from Methodologies.* Any material changes to, or material deviations from, the fair value methodologies established

¹⁰² See MFDF Valuation Report, *supra* footnote 97, at 14.

¹⁰³ Fund boards could always request additional information if they so choose. Proposed rule 2a-5(b)(1)(i)(F).

¹⁰⁴ Proposed rule 2a-5(b)(1)(i)(A). See *supra* section II.A.1 discussing this process. For example, the adviser could discuss instances where it challenged the pricing information provided by an affiliated or third party vendor.

under the proposed rule.¹⁰⁵ This requirement would keep boards informed of such changes or deviations, which may show that the methodologies need to be updated or adjusted, and provide an opportunity for a board to ask questions regarding the reasons for any change or deviation.

- *Testing Results.* The results of any testing of fair value methodologies as part of the required fair value policies and procedures.¹⁰⁶ As discussed above, the requirement to test the appropriateness and accuracy of the methodologies used to calculate fair value is designed to help ensure that the selected fair value methodologies are appropriate and that adjustments to the methodologies are made where necessary.
- *Resources.* The adequacy of resources allocated to the process for determining the fair value of the fund's assigned investments, including any material changes to the roles or functions of the persons responsible for determining the fair value.¹⁰⁷ The adviser's assessment of the adequacy of these resources may inform a board in determining the level of scrutiny to apply in overseeing an adviser's fair value determinations.

¹⁰⁵ Proposed rule 2a-5(b)(1)(i)(B). For example, a report could discuss when key inputs or assumptions are changed and the reasons for the changes. We believe that both a material change and the reason for it would be information that may be reasonably necessary for the board to evaluate such changes.

¹⁰⁶ Proposed rule 2a-5(b)(1)(i)(C).

¹⁰⁷ Proposed rule 2a-5(b)(1)(i)(D). For example, an adviser should disclose to the board when the adviser seeks to hire a new pricing service to cover a new asset type or when replacing a person with a background in valuation with a person without that background in a position of authority regarding the adviser's fair value process. *See also* proposed rule 2a-5(b)(2).

- *Pricing Services.* Any material changes to the adviser’s process for overseeing pricing services,¹⁰⁸ as well as any material events related to its oversight of such services, such as changes of service providers used or price overrides.¹⁰⁹ This information is designed to help the board oversee the adviser’s use of pricing services, if applicable, and to help ensure that pricing information received from service providers serves as a reliable input for determining fair value in good faith.
- *Other Requested Information.* Any other materials requested by the board related to the adviser’s process for determining the fair value of fund investments.¹¹⁰

These requirements collectively are designed to help ensure that boards obtain the information that they need to exercise their statutory and fiduciary duties and to oversee an adviser. They are intended to supplement, not replace, this oversight. Boards should critically review the information provided to them, particularly with regard to an adviser’s reporting on its own conflicts of interest, and request any information that they feel is necessary to conduct that oversight. For example, in addition to the specific items listed above,¹¹¹ a board could review and consider, if relevant:

¹⁰⁸ If the board assigns the fair value determination to an adviser under the proposed rule, the board would generally be aware of an adviser initially appointing, and the establishment of the process for overseeing, a pricing service as part of its oversight and approval of the adviser’s policies and procedures under rule 38a-1. As a result, we are not specifically proposing to require that information be included in these periodic reports.

¹⁰⁹ Proposed rule 2a-5(b)(1)(i)(E). There may be times when pricing information from a pricing vendor differs materially from the adviser’s view of the then-current fair value of the portfolio holding, and the adviser may seek to contact the pricing vendor to question the basis for the pricing information. Because this difference in pricing suggests that further inquiry is needed to assess the adequacy of the fair value process when these conflicts occur, we are proposing to require this reporting.

¹¹⁰ Proposed rule 2a-5(b)(1)(i)(F).

¹¹¹ Boards and fund CCOs may also consider requesting or including items such as the examples given in the bullet list below, if relevant, as part of the CCO’s annual reports to the board under rule 38a-1(a)(4)(iii).

- Summaries of adviser price challenges to pricing information provided by third-party vendors and of price overrides, including back-testing results related to the use of price challenges and overrides;
- Specific calibration and back-testing data, including in the case of back-testing whether fair value prices moved in the same direction (relative to the prior market prices) as the portfolio holdings' next actual market prices, whether fair value prices were closer to the portfolio holdings' next actual market prices than the prior market prices (regardless of the direction), and whether the difference between the fair value prices and the subsequent prices was greater than pre-established tolerance levels;¹¹²
- Reports regarding portfolio holdings for which there has been no change in price or for which investments have been held at cost for an extended period of time ("stale prices");
- Reports regarding portfolio holdings whose price has changed outside of predetermined ranges over a set period of time;
- Narrative summaries or reports on pricing errors, including the date of any error, the cause, the impact on the fund's NAV, and any remedial actions taken in response to the error;
- Reports on the adviser's due diligence of pricing services used by the fund;

¹¹² See *supra* footnote 57. In these cases, reports on back-testing could indicate whether fair value is being compared to actual sales prices or to pricing information from pricing services and dealers. In the latter case, the reports could state whether dealer prices are actual bids or firm commitments or are indicative or accommodation quotes that merely represent the opinion of the dealer.

- The results of testing by the fund's independent auditor provided to the audit committee;
- Reports analyzing trends in the number of the fund's portfolio holdings that received a fair value, as well as the percent of the fund's assets that received a fair value; and
- Reports on the number and materiality of securities whose fair values were determined based on information provided by broker-dealers; the broker-dealers most frequently used for this purpose; and the results of back-testing on the information they provided.

We request comment on our proposed requirement that advisers periodically provide a written evaluation of the adequacy and effectiveness of the adviser's process for determining the fair value of the assigned portfolio of investments, including, at a minimum, certain specified summaries or descriptions.

28. Is the proposed periodic reporting requirement appropriate? What resources would be required for an adviser to provide the required quarterly assessment of the adequacy and effectiveness of the adviser's process? Are there additional or different matters that we should require advisers to address in the periodic reports? Are there some items that we should not require? If so, which, and why?
29. Should we require a different minimum reporting frequency for periodic reports? Should we, for example, require advisers to provide these reports monthly or in connection with each regularly scheduled board meeting? Should we require some or all of the specified information to be provided less frequently, such as annually?

30. Is what should be included in an assessment clear? Should we include additional guidance to explain what this entails? Are the other key terms used in the proposal, such as “assess,” and “material” sufficiently understood or is further guidance advisable for those terms? Should they be defined in the rule, and, if so, how? Should the rule use different terms, and, if so, which terms?
31. Are there circumstances in which boards should receive specific information on each individual portfolio holding that received a fair value during the quarter or certain such holdings?
32. We are proposing to require that all price overrides be reported as supplemental information to the board as part of the periodic report. Should we limit which price overrides must be reported, and, if so, how? Alternatively or in addition, should we require reporting regarding all price challenges, even those that do not lead to overrides?
33. Is there additional specific information that we should require to be part of these periodic reports? Are there any other reports that some boards currently receive that should be required under the proposed rule?
34. In light of their importance, should the rule impose specific requirements beyond reporting regarding pricing services? For example, should any pricing services used be explicitly approved by the board? Should there be a required finding or report by the adviser as to pricing services’ adequacy and effectiveness?

b. Prompt Board Reporting

We also believe that it is important for the adviser to notify the board of certain issues as they arise that may require their immediate attention. Proposed rule 2a-5 would require that the

adviser promptly report to the board in writing 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 a material weakness in the design or implementation of the adviser’s fair value determination process or material changes¹¹³ in the fund’s valuation risks.¹¹⁴ These reports, like the periodic reports discussed above, also must include such information as may be reasonably necessary for the board to evaluate the matter covered in the report.

“Could have materially affected” is intended to capture certain circumstances where, for example, a matter was detected which affected one security and which may not be material on its own, but, had the matter not been identified, could have materially affected the larger assigned portfolio of investments or some subset of that portfolio.¹¹⁵ This concept is not intended to mandate reporting in circumstances where, at the time the matter was detected, it did not seem that the matter would materially affect the fair value of the assigned portfolio but the matter later ended up having such an effect.

We are proposing to require the adviser to provide these reports promptly, but in no event later than three business days after the adviser becomes aware of the matter, rather than waiting until the next periodic report.¹¹⁶ We believe it is appropriate that the board receive prompt reports regarding matters that materially affect fair value determinations because the proposed

¹¹³ For example, a significant increase in price challenges or overrides likely would reflect a material change to the fund’s valuation risks that should be promptly reported to the board,

¹¹⁴ Proposed rule 2a-5(b)(1)(ii).

¹¹⁵ See PCAOB AS 2201 An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements, Appendix A - Definitions .A7 (defining “material weakness” and “reasonable possibility”). See also Sarbanes-Oxley Act, *supra* footnote 21, at Title III Sec. 302(a)(5).

¹¹⁶ *Id.*

rule would allow the board to assign to an adviser fair value determinations otherwise allocated to the board under the Act, and there may arise an issue of such importance that requires prompt board attention. We recognize that the kind of matters that may require this prompt reporting (*i.e.*, outside of the periodic reports) may vary. Some situations may warrant an immediate report, while in other cases it may be appropriate for the adviser to take some additional time to evaluate how to address the matter before engaging the board. We believe that requiring such a report to be “prompt,” but in no event later than three business days after the adviser becomes aware, balances the need for the board to be timely informed of material valuation issues, while allowing the adviser to evaluate and respond appropriately.

We also understand, however, that there may be some circumstances when an adviser becomes aware of an issue that may affect fair value of the portfolio but that the materiality of a given event may be in question. In such a case, an adviser may need additional time to determine and verify whether an event has or could materially affect the fair value of the portfolio assigned to the adviser. Accordingly, we believe that if an adviser needs some reasonable amount of time after becoming aware of the matter to verify and determine its materiality, that verification period would not be counted as part of the “prompt” trigger period. In general, we believe that this verification and final determination process should be completed within three business days or less, including the day that the adviser became aware of the triggering event. Therefore, any prompt reports generally should occur no more than three business days after the adviser becomes aware of the event, but the adviser may, to the extent necessary, take limited additional time (but in no event more than three business days) for the verification and final determination process.

We request comment on our proposed requirement regarding prompt reporting on certain matters associated with the adviser's process that materially affect, or could have materially affected, the fair value of the assigned portfolio of fund's investments.

35. Are the proposed prompt reporting requirements appropriate? Are there additional or different matters that we should require advisers to address in their prompt reports?
36. Should the trigger for prompt reporting be tied to a specific bright line or instead be dependent on facts and circumstances? For example, instead of the trigger being when the adviser becomes aware of the matter should it instead be when the event occurs? If so, would advisers reasonably be able to know when such events occur such that they could report in a timely fashion? Alternatively, should it be when the adviser determines and verifies the impact of the event regardless of how long it takes after the adviser becomes aware of the matter?
37. Are the standards of "materially affecting" or "could have materially affected" sufficiently understood? Should we provide more context on what these terms mean, specifically as they relate to the context of material weaknesses? Should we instead adopt a different standard, such as one that uses specific triggers, to identify matters for prompt reporting? If so, which triggers? For example, should we instead require reporting when a specific number of price overrides have occurred?
38. Should we identify any other issues that the adviser should report promptly to the board? For example, instead of requiring any changes to the fund's fair value methodologies to be reported during the periodic reports, should we instead

require that they also be reported promptly? Alternatively, are there matters that would be required to be reported promptly that should instead be reported as part of the periodic report?

39. Is the specified timeline for prompt reporting appropriate or should we consider different time frames? For example, should we require that an adviser report to the board within 1 or 10 business days? Should the time frame be different for certain types of circumstances? If so, which ones?
40. Will advisers be able to make the appropriate determinations in the limited time discussed above? Will advisers need more than three business days to make such a materiality decision? Is three days too long? Should we specify a time for making materiality decision in the rule?
41. The proposed rule would require all reports to be in writing, including prompt reports. Should we provide that in the case of prompt reports, advisers could make oral reports so long as adequate records are kept?
42. Should we require that, if the report is not made to the full board, the designated board committee make a report to the full board within a specified time frame, such as at the next regularly scheduled meeting?
43. Should we permit the adviser to make prompt reports to a pre-identified individual director? What controls should we require if we did permit this? For example, should that director be required to be one of the independent directors?

3. *Specification of Functions*

If the board assigns the fair value determination requirements for one or more fund investments to an adviser, the proposed rule would require the adviser to specify the titles of the

persons responsible for determining the fair value of the assigned investments, including by specifying the particular functions for which the persons identified are responsible.¹¹⁷ If the adviser uses a valuation committee or similar body to assist in the process of determining fair value, the fair value policies and procedures generally should describe the composition and role of the committee, or reference any related committee governance documents as appropriate. In addition, the fair value policies and procedures also should identify the specific personnel with duties associated with price challenges, including those with the authority to override a price, and the roles and responsibilities of such persons, and establish a process for the review of price overrides.¹¹⁸

In addition, the proposed rule would require the adviser to reasonably segregate the process of making fair value determinations from the portfolio management of the fund.¹¹⁹ One significant source of potential adviser conflicts of interest in the fair value determination process is the level and kinds of input that fund portfolio managers or persons in related functions have in the design or modification of fair value methodologies, or in the calculation of specific fair values.¹²⁰ In many circumstances, the fund's portfolio manager may be the most knowledgeable person at an investment adviser regarding a fund's portfolio holdings. For this reason, it may be appropriate for portfolio managers to provide input into the process for determining the fair value of fund investments. On the other hand, because portfolio management personnel are often

¹¹⁷ Proposed rule 2a-5(b)(2).

¹¹⁸ *See also* proposed rule 2a-5(a)(4).

¹¹⁹ *See* *In re Morgan Asset Management*, *supra* footnote 9.

¹²⁰ *Id.* at 4 (fund's portfolio manager "actively screened and influenced a broker-dealer to change the price confirmations [and] failed to advise ... when he received information indicating that the Fund's prices for certain securities should be reduced.").

compensated in part based on the returns of the fund, a portfolio manager's incentives may not be fully aligned with the fund's with respect to determination of fair value, and a portfolio manager therefore should not be making the fair value determinations.¹²¹

Further, we believe that a fund generally should consider the extent of influence portfolio managers may have on administration of the fair value process, and seek to provide independent voices and administration of the process as a check on any potential conflicts of interest to the extent appropriate.¹²² Separation of functions facilitates these important checks and balances, and funds could institute this proposed requirement through a variety of methods, such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel. The proposed rule would require reasonable segregation of functions, rather than taking a more prescriptive approach, such as requiring funds to implement strict protocols regarding communications between specific personnel, to allow funds to structure their fair value determination process and portfolio management functions in ways that are tailored to each fund's facts and circumstances, including the size and resources of the fund's adviser. In this regard, the reasonable segregation requirement is not meant to indicate that portfolio management must necessarily be subject to a communications "firewall." We recognize the important perspective and insight regarding the value of fund holdings that portfolio management personnel can provide. Accordingly, this segregation requirement would not prevent portfolio managers from providing inputs that are used in the fair value determination

¹²¹ In addition, as the person most directly responsible for the fund's investments, the portfolio manager may also be concerned about the reputational or career implications of the fund's performance, or its compliance with investment limitations, which can provide an incentive to smooth returns or otherwise misvalue portfolio holdings.

¹²² See Liquidity Risk Management Release, *supra* footnote 3, at section III.H.1

process, as noted above. Instead, this reasonable segregation requirement is designed to help reduce and manage potential conflicts of interest. Keeping the functions reasonably segregated in the context of fair value determinations should help mitigate the possibility that these competing incentives diminish the effectiveness of fair value determinations.

We request comment on this proposed requirement.

44. Should the rule require assigned advisers to reasonably segregate the process of making fair value determinations from the portfolio management of the fund?

Would this pose any difficulty for particular types of entities, for example funds managed by small advisers?

45. Is there a better way to prevent conflicts between a portfolio manager's incentives and a fund's interest, for example, in determination of investment values that do not result in dilution of purchasing or redeeming investors? Should we provide any additional clarification regarding the proposed reasonable segregation requirement? If so, what changes should we make? Should we add or change any specific requirements? For example, should we prohibit portfolio management from having any involvement in the fair value process or should we generally prohibit their involvement outside of certain situations beyond making fair value determinations? If so, what level of involvement should we permit? Further, should we exempt smaller advisers from this requirement or clarify that this is a key risk and thus, where feasible, such personnel should be segregated, without making segregation an explicit regulatory requirement? Are there effective steps, other than segregation, that funds currently use to manage the potential conflicts

of portfolio management personnel that the rule should require instead of segregation? If so, what are they and why should they be required instead?

4. *Records of Assignment*

Under the proposed rule, in addition to the records that would need to be kept as part of a good faith determination of fair value generally, a fund must also keep records related to the fair value determinations assigned to the adviser. Specifically, the fund would be required to: (1) keep copies of the reports and other information provided to the board required by the rule and (2) a specified list of the investments or investment types whose fair value determinations have been assigned to the adviser pursuant to the requirements of the proposed rule.¹²³ In each case, these records would be required to be kept for at least five years after the end of the fiscal year in which the documents were provided to the board or the investments or investment types were assigned to the adviser, the first two years in an easily accessible place.¹²⁴

As discussed above, funds must create and retain certain documentation, including the reports that advisers make to the fund board.¹²⁵ Further, we believe that a clear identification of the investments or investment types that the board has assigned to the adviser would facilitate the board's oversight of the adviser's fair value determinations.¹²⁶ These proposed recordkeeping requirements are designed to achieve these objectives and to facilitate compliance, and related regulatory oversight, with the proposed rule.

We request comment on these proposed additional recordkeeping requirements.

¹²³ Proposed rule 2a-5(b)(3).

¹²⁴ Proposed rule 2a-5(b)(3).

¹²⁵ *See supra* section II.A.6.

¹²⁶ Proposed rule 2a-5(b)(3).

46. Are there any additional types of records that we should require the fund to maintain in connection with the assignment process? Why or why not?
47. Should we apply any or all of the proposed recordkeeping requirements of this section to the adviser, rather than the fund? If so, which requirements?
48. Are the holding periods sufficient to evidence compliance? Why or why not? Should they be different (*e.g.*, six years)?

C. Readily Available Market Quotations

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. Under section 2(a)(41) of the Investment Company Act, if a market quotation is readily available for a portfolio holding, it must be valued at the market value. Conversely, if market quotations are “not readily available,” the holding’s value must be fair value as determined in good faith by the board.¹²⁷

Neither the Investment Company Act nor the rules thereunder currently define “readily available.” However, we understand that industry practice has developed to incorporate many of the concepts of ASC Topic 820 when evaluating whether market quotations are readily available.¹²⁸

The proposed rule would provide that a market quotation is readily available for purposes of section 2(a)(41) of the Investment Company Act with respect to an investment only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund

¹²⁷ Section 2(a)(41).

¹²⁸ We acknowledge that specific references and principles in U.S. GAAP may change over time. When referencing ASC Topic 820 throughout this release, we intend to reference the accounting topic on Fair Value Measurements within U.S. GAAP and the principles therein.

can access at the measurement date, provided that a quotation will not be readily available if it is not reliable.¹²⁹ Fair value, as defined in the Act, therefore must be used in all other circumstances.¹³⁰ As discussed previously, we believe that for a fair value methodology to be appropriate under the proposed rule, it must be determined in accordance with U.S. GAAP. As mentioned above, U.S. GAAP requires funds to maximize the use of relevant observable inputs and minimize the use of unobservable inputs. However, under U.S. GAAP there are circumstances where otherwise relevant observable inputs become unreliable.¹³¹ Consistent with this, a quote would be considered unreliable under proposed rule 2a-5(c) in the same circumstances where it would require adjustment under U.S. GAAP or where U.S. GAAP would require consideration of additional inputs in determining the value of the security. For example, under current U.S. GAAP, funds looking to the proposed rule would use previous closing prices for securities that principally trade on a closed foreign market to calculate the value of that security, except when an event has occurred since the time the value was established that is likely to have resulted in a change in such value.¹³² In such circumstances, the fund would need to fair value the security.

¹²⁹ Proposed rule 2a-5(c). ASC Topic 820 defines level 1 inputs as “[q]uoted prices (unadjusted) in active markets for *identical* assets . . . that the reporting entity can access at the measurement date.” ASC Topic 820-10-20 (emphasis added). In ASR 113, the Commission interpreted “readily available market quotations” to refer “to reports of current public quotations for securities similar in all respects to the securities in question.” Despite the respective references to “securities similar in all respects” in the Commission’s prior guidance and “identical assets” in ASC Topic 820, we view these respective definitions as being substantively the same.

¹³⁰ Proposed rule 2a-5(e)(2). *See also supra* section II.A.2.

¹³¹ *See* ASC Topic 820-10-35-41C (outlining circumstances when a reporting entity shall make an adjustment to a Level 1 input).

¹³² *See id.* at b.

As we have stated previously, evaluated prices are not, by themselves, readily available market quotations.¹³³ In addition, “indications of interest” and “accommodation quotes,” for example, would not be “readily available market quotations” for the purposes of proposed rule 2a-5.¹³⁴

We request comment on our proposed definition of when market quotations are readily available for purposes of section 2(a)(41) and rule 2a-4.

49. Is the proposed definition of when market quotations are readily available under the Investment Company Act appropriate? Should we look elsewhere than or in addition to ASC Topic 820?
50. How should we address investments in pooled vehicles, such as registered investment companies, that are valued at NAV, not at a market price? Do funds currently treat such investments as securities that are fair valued? What would be the burdens on boards of funds that invest substantially in such vehicles (*e.g.*, funds of funds)? To the extent that a board assigned the determination of fair values of such investments to a fund’s adviser, would the adviser’s use of NAV involve the conflicts of interest or other concerns underlying paragraph (b) of the proposed rule?
51. Would this provision cause any compliance issues with other elements of the proposed rule, ASC Topic 820, or any other provision of the federal securities laws?

¹³³ See 2014 Money Market Fund Release *supra* footnote 14, at text accompanying n.895.

¹³⁴ See Liquidity Risk Management Release, *supra* footnote 3, at nn.800-801 and accompanying text.

52. This definition is designed to track concepts in U.S. GAAP. Should we instead expressly refer to U.S. GAAP in the rule text to ensure that consistency with U.S. GAAP in case of changes over time? For example, should the rule instead provide that “market quotations are readily available for purposes of section 2(a)(41) of the Act with respect to an investment only when the investment’s value is determined under generally accepted accounting principles of the United States based solely on quoted, unadjusted prices in active markets for identical investments that the fund can access at the measurement date?”
53. Should the Commission define readily available market quotations via rulemaking as proposed, or should we instead provide interpretive guidance?
54. Do practitioners understand what it means in this context for the fund to have access to identical investments at the measurement date? Should some other standard be used, such as “readily access” or “reasonably access”?

D. Rescission of Prior Commission Releases

In ASR 113 and ASR 118, the Commission provided specific guidance for funds regarding the “inclusion” (or recognition), “valuation” (or measurement), and disclosure of investment securities.¹³⁵ Since the Commission issued that guidance, we believe that developments in the FASB accounting standards have modernized the approach to accounting topics addressed in ASR 113 and ASR 118. Further, as noted above, market and fund

¹³⁵ See ASR 113 (“1. The Problems of Valuation” and “2. The Problems of Portfolio Management”); ASR 118. ASR 118 refers to the concepts of “inclusion” and “valuation” of securities in the portfolio, which we believe are equivalent to the U.S. GAAP concepts of recognition and measurement, respectively.

investment practices have evolved considerably.¹³⁶ As a result, the fund-specific accounting guidance for recognition, measurement, and disclosure provided in those statements may no longer be necessary.

Several examples illustrate how FASB accounting standards have addressed the topics covered in the ASRs. First, ASR 118 provides guidance related to the “inclusion,” or recognition, of securities in a portfolio. Today, U.S. GAAP provides authoritative standards applicable to the recognition of investments by investment companies for financial reporting purposes.¹³⁷ For example, ASC Topic 946: *Financial Services – Investment Companies* (“ASC Topic 946”) requires that an investment company recognize security purchases and sales as of the date on which the investment company agrees to purchase or sell the investment.¹³⁸ It also provides that securities acquired in private placements and tender offers are required to be recognized as of the date the investment company obtained legal rights and obligations relating to the transferred securities.¹³⁹

In addition, ASRs 113 and 118 provide guidance related to the valuation and disclosure of securities for financial reporting purposes. Again, U.S. GAAP provides authoritative standards applicable to the measurement of fund investments and related disclosures for financial reporting purposes. For example, ASC Topic 946 requires that investment companies measure

¹³⁶ See *supra* section I.

¹³⁷ Rule 2a-4(a)(2) under the Investment Company Act provides that, for purposes of calculating the NAV of a redeemable security, “changes in holdings of portfolio securities shall be reflected no later than in the first calculation on the first business day following the trade date.” The “first business day following the trade date” is commonly referred to as T+1. We believe that our proposed rescission of ASR 113 and ASR 118 is consistent with the provisions of rule 2a-4.

¹³⁸ See ASC 946-320-25-1.

¹³⁹ See ASC 946-320-25-2.

investments in debt and equity securities, as well as other investments, at fair value.¹⁴⁰ ASC Topic 820, in turn, defines “fair value” as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”¹⁴¹ ASC Topic 820 also provides a framework for measuring fair value as well as principles for financial statement disclosures.¹⁴²

The Commission historically has recognized FASB pronouncements as authoritative for financial reporting purposes in the absence of any contrary Commission determination.¹⁴³ In Financial Reporting Release No. 70,¹⁴⁴ the Commission stated its determination that the FASB and its parent organization, the Financial Accounting Foundation, satisfied the criteria in section 19(b) of the Securities Act and, accordingly, FASB financial accounting and reporting standards are recognized as “generally accepted” under the federal securities laws.¹⁴⁵ As a result, registrants are required to comply with those standards for recognition, measurement and disclosure in preparing financial statements filed with the Commission, unless the Commission provides otherwise.¹⁴⁶ Accordingly, we believe ASR 113 and ASR 118 are not necessary to clarify fund obligations with respect to these accounting topics. We further believe that, because the guidance contained in ASR 113 and ASR 118, on the one hand, and U.S. GAAP, on the

¹⁴⁰ See ASC 946-320-35-1 and ASC 946-325-35-1.

¹⁴¹ As noted above, the term “fair value” is used in sections II.A and II.B as defined in ASC Topic 820. See *supra* footnote 13.

¹⁴² ASC Topic 820 defines fair value at ASC 820-10-20. See also ASC Topic 820-10-50.

¹⁴³ See Rule 4-01(a)(1) of Regulation S-X [17 CFR 210.4-01(a)(1)]. See also ASR 150 (Dec. 20, 1973) and ASR 4 (Apr. 25, 1938).

¹⁴⁴ Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Investment Company Act Release No. 26028 (Apr. 25, 2003) [68 FR 23333 (May 1, 2003)] (“FR-70”).

¹⁴⁵ 15 U.S.C 77s(b).

¹⁴⁶ See FR-70, *supra* footnote 144; rule 4-01(a)(1) of Regulation S-X.

other, require funds to reach similar results with respect to the recognition, measurement, and disclosure of fund portfolio holdings, such guidance is not necessary to supplement the requirements of U.S. GAAP. We believe that the measurement concepts under ASC Topic 820 are consistent with the Investment Company Act and the Commission’s prior statements that fair value is the amount that an owner of a portfolio holding might reasonably expect to receive upon its “current sale.”¹⁴⁷ As a result, we propose to rescind the Commission’s prior guidance in ASR 113 and ASR 118.¹⁴⁸ Additionally, in light of the Sarbanes-Oxley Act giving the PCAOB the authority to establish or adopt professional standards for auditors, subsequent to the release of the Commission guidance in ASR 118, we no longer believe that it is necessary to retain the specific requirement in ASR 118 for an independent accountant of a fund to verify all quotations for securities with readily available market quotations at the balance sheet date. Accordingly, we are proposing to rescind ASR 118, including this specific requirement.¹⁴⁹

In addition to the discussions in ASR 113 and ASR 118 regarding accounting, auditing, and the role of the board in determining fair value, these releases also discuss other matters.

Because we believe that many of these statements would be superseded by the rule we are

¹⁴⁷ In ASR 118 the Commission stated that, as a general principle, fair value of a security would be the amount that a fund might reasonably expect to receive for the security upon its current sale. (The “current sale” standard also is referred to as the “exit price” standard.) In U.S. GAAP, ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability between market participants at the measurement date under current market conditions (an exit price).

¹⁴⁸ We also are proposing to make conforming amendments to 17 CFR 210.6-03 (rule 6-03 of Regulation S-X).

¹⁴⁹ The proposed rescission would eliminate the Commission’s auditing guidance to verify all quotations of securities with readily available market quotations at the balance sheet date, implicating the auditor’s requirement to test the valuation assertion for all securities. This proposal does not impact the statutory requirement in section 30(g) of the Investment Company Act, which requires the independent public accountant to verify securities owned, either by actual examinations, or by receipt of a certificate from the custodian, which implicates the auditor’s requirement to test the existence assertion for all securities. The statutory requirement under section 30(g) of the Investment Company Act remains distinct from the requirements in auditing standards established by the PCAOB.

proposing here, or have also been superseded by subsequent requirements under U.S. GAAP, we propose to rescind ASR 113 and ASR 118 in their entirety.¹⁵⁰ We continue to believe that the improper valuation of fund investments that materially affects the NAV of the shares being offered or, in the case of an open-end fund, redeemed, could violate the anti-fraud provisions of the federal securities laws.¹⁵¹

We do not propose to modify the Commission's prior guidance regarding the use of the amortized cost method because the Commission recently considered this topic in the 2014 Money Market Fund Release, and we do not believe that further guidance in this area is required at this time.¹⁵²

55. Do commenters agree that all of the guidance provided in ASR 113 and ASR 118 has been rendered unnecessary by subsequent developments, including developments in the fund industry, subsequent Commission statements, rulemakings, and developments related to U.S. GAAP, and the requirements of the proposed rule, if adopted? Is there any guidance contained in either of ASR

¹⁵⁰ The discussion of liquidity in ASR 113 under the heading "2. The Problems of Portfolio Management" has been rendered moot by the adoption of rule 22e-4 on liquidity risk management programs. The discussion in ASR 113 under the heading "3. The Problem of Disclosure" has been rendered obsolete by the repeal of Form N-8B-1 and the adoption of our current disclosure forms. *See, e.g.*, Investment Company Registration and Report Forms and Reporting Requirements, Revision of Forms, Reports and Regulations, Investment Company Act Release No. 10378 (Aug. 28, 1978) ("Forms N-1 and N-2 . . . replace Form N-8B-1"); Registration Form Used by Open-End Management Investment Companies; Guidelines, Investment Company Act Release No. 13436 (Aug. 22, 1983) (Form N-1A replaces Form N-1); Form N-1A; Form N-2.

¹⁵¹ *See also* ASR 113.

¹⁵² *See* 2014 Money Market Fund Release *supra* footnote 14. *See also* Accounting Series Release No. 219, Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, (May 31, 1977) (stating that, under certain circumstances, funds may determine the fair value of debt securities that mature in 60 days or fewer by using the amortized cost method).

113 and ASR 118, accounting or otherwise, that commenters believe it is necessary or desirable to retain?

56. To the extent prior guidance has not already been incorporated into U.S. GAAP, is there any prior guidance that should be recommended for incorporation into U.S. GAAP by the FASB?
57. We have previously stated that fair value is what “the owner might reasonably expect to receive . . . upon [a] current sale.”¹⁵³ Are the concepts of “current sale” in ASR 118 and “exit price” in U.S. GAAP identical? If not, what are the differences between the two standards and how should we address such gap?
58. The proposal does not address the views the Commission has expressed related to the use of amortized cost in valuing portfolio securities with maturity dates of 60 days or less.¹⁵⁴ Is there other valuation guidance that the proposal should address? Do funds or advisers look to any other guidance on valuation that would be relevant for the Commission to address?
59. Our proposal to rescind ASR 118 would eliminate the Commission’s statement in that release regarding verification by an independent accountant of all quotations for securities with readily available market quotations at the balance sheet date. Should we maintain that position regarding independent verification of quotations for all securities for which market quotations are available? What are the benefits

¹⁵³ ASR 118.

¹⁵⁴ See 2014 Money Market Fund Release, *supra* footnote 14. These views were codified in the “Codification of Financial Reporting Policies” at section 404.05.c.

or costs associated with independent verification of quotations for all portfolio investments?

60. Is there any other Commission valuation rule (such as rule 6.02(b) of Regulation S-X) or guidance that we should consider rescinding or amending in light of the proposal? If so, why?

E. Existing Staff No-Action Letters, Other Staff Guidance, and Proposed Transition Period

In addition to the proposal to rescind ASR 113 and ASR 118, certain staff letters and other staff guidance addressing a board’s determination of fair value and other matters covered by proposed rule 2a-5 would be withdrawn or rescinded in connection with any adoption of this proposal. Upon the adoption of any final rule, some letters and other guidance, or portions thereof, would be moot, superseded, or otherwise inconsistent with the final rule and, therefore, would be withdrawn or rescinded. If commenters believe that additional letters or other guidance, or portions thereof, should be withdrawn or rescinded, they should identify the letter or guidance, state why it is relevant to the proposed rule, how it or any specific portion thereof should be treated, and the reason therefor. Based on the proposed rule, staff letters and guidance that would be withdrawn or rescinded would include, but would not necessarily be limited to, all of the staff letters and other staff guidance listed below.

Name	Date	Topic
Paul Revere Investors, Inc.	Feb. 21, 1973	Delegation to a board valuation committee.
The Putnam Growth Fund and Putnam International Equities Fund, Inc.	Jan. 23, 1981	Fair value of portfolio securities which trade on a closed foreign exchange.
Form N-7 for Registration of Unit Investment Trusts under the Securities Act of 1933 and the Investment Company Act	Mar. 17, 1987	Fair value for UITs to be determined by the trustee or its appointed person.

of 1940, Investment Company Act Release No. 15612, Appendix B, Guide 2		
Investment Company Institute	Dec. 8, 1999	Fair value generally.
Investment Company Institute	Apr. 30, 2001	Fair value generally.
Valuation Guidance Frequently Asked Questions (FAQ 1 <u>only</u>)	2014	Fund directors' responsibilities when determining whether an evaluated price provided by a pricing service, or some other price, constitutes fair value.

We also are proposing a one-year transition period to provide time for funds and their advisers to prepare to come into compliance with proposed rule 2a-5. Accordingly, we propose that the effective date of any adoption of this proposal would be one year following the publication of the final rule in the Federal Register. We propose to rescind ASR 113 and 118 at that time, and the identified guidance would be withdrawn.

We request comment on the proposed rescissions and transition period.

61. Are there any other staff letters or guidance pieces that should be rescinded or withdrawn should proposed rule 2a-5 be adopted?
62. Alternatively, should the Commission codify any staff letters or other staff guidance pieces, for example, FAQ 2 in the 2014 Valuation Guidance Frequently Asked Questions? If so, commenters should identify the positions and explain why commenters believe they should be codified.
63. Do commenters agree that a one-year transition period to provide time for funds and their advisers to prepare to come into compliance with proposed rule 2a-5 is appropriate? Should the period be shorter or longer?
64. Should the transition period be the same for all funds that would be subject to proposed rule 2a-5, as proposed? Alternatively, should we adopt tiered transition periods for smaller entities? For example, should we provide an additional six

months in the transition period for smaller entities (or some other shorter or longer period)?

65. Instead of a fixed transition period of one year, should we tie the transition period to the fiscal year end of funds? For example, should the transition period instead start for each fund at the beginning of its fiscal year end after the one-year period following adoption of any rule?

III. ECONOMIC ANALYSIS

A. Introduction

The proposed rule would provide requirements for determining fair value in good faith for purposes of section 2(a)(41) of the Act and rule 2a-4 thereunder. This determination would involve assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; evaluating any pricing services used; adopting and implementing certain written policies and procedures; and maintaining certain records.¹⁵⁵ The proposed rule would permit a fund's board of directors to assign the fair value determination relating to any or all fund investments to an investment adviser of the fund, which would carry out all of the functions required under the rule, subject to board oversight and certain reporting, recordkeeping, and other requirements designed to facilitate the board's ability to effectively oversee the adviser's fair value determinations.¹⁵⁶ Finally, the proposed rule would define when market quotations are readily available for purposes of section 2(a)(41) of the

¹⁵⁵ See proposed rule 2a-5(a).

¹⁵⁶ See proposed rule 2a-5(b).

Act.¹⁵⁷ We are sensitive to the economic effects that may result from the proposed rule, including the benefits, costs, and the effects on efficiency, competition, and capital formation.¹⁵⁸ Section 2(c) of the Investment Company Act requires us, when engaging in rulemaking that requires us to consider or determine whether an action is consistent with the public interest, to also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

The proposed rule would provide a consistent framework for boards to comply with their obligations under section 2(a)(41) of the Investment Company Act and would permit boards to assign fair value determinations to an investment adviser, which would carry out all of the functions required under the proposed rule, subject to oversight and other conditions. Permitting a fund's board to assign fair value determinations to an investment adviser recognizes the developments discussed in Section I above, including the increased complexity of many fund portfolios and the in-depth expertise needed to accurately fair value such complex investments. The proposed rule also recognizes the important role that fund investment advisers now play and the expertise they provide in the fair value determination process given market and regulatory developments over the past fifty years. Permitting a fund's board to assign fair value determinations to the adviser would allow the board to focus its time and attention on other matters related to the fund, such as the oversight of the investment adviser. This could lead to a more efficient use of boards' resources and therefore improve funds' governance for the benefit

¹⁵⁷ See proposed rule 2a-5(c).

¹⁵⁸ Our analysis of the proposed rule takes into account the rescission of ASR 113 and ASR 118 as well as the withdrawal and rescission of certain staff letters and other guidance addressing a board's determination of fair value and other matters covered by proposed rule 2a-5 (see Sections II.D. and II.E. above).

of fund investors. The proposed rule would impose one-time costs to funds to review the proposed rule's requirements and modify their fair value practices, policies and procedures, reporting, and recordkeeping to comply with the proposed rule. Further, to the extent that fair value determinations would be assigned to a fund's investment adviser, the investment adviser may have to incur ongoing costs to satisfy the new fair value obligations. The investment adviser ultimately may pass through some of these ongoing costs to funds and their investors.

We discuss the potential effects of the proposed rule as well as possible alternatives to the proposed rule in more detail below. Where possible, we have attempted to quantify the costs, benefits, and effects on efficiency, competition, and capital formation expected to result from the proposed rule. In some cases, however, we are unable to quantify the economic effects because we lack the information necessary to provide a reliable estimate. Where we are unable to quantify the economic effects of the proposed rule, we provide a qualitative assessment of the potential effects and encourage commenters to provide data and information that would help quantify the benefits, costs, and the potential impacts of the proposed rule on efficiency, competition, and capital formation.

B. Economic Baseline

1. Current regulatory framework

To understand the effects of the proposed rule, we compare the proposed rule's requirements to the current regulatory framework and current industry practices. As discussed in greater detail in Section I above, the regulatory framework regarding fair value determinations and the role of the board of directors in the determination of fair value is set forth in the Investment Company Act and the rules thereunder. The Commission has also expressed its views on the role of the board regarding fair value under the Investment Company Act in several

releases, including ASR 113 and ASR 118, the 2014 Money Market Fund Release, and the Compliance Rules Adopting Release.¹⁵⁹

Section 2(a)(41) of the Investment Company Act defines the value of assets for which market quotations are not readily available as fair value as determined by the board of directors in good faith. As discussed above, the Commission acknowledged in ASR 113 and ASR 118 that the board need not itself perform each of the specific tasks required to calculate fair value in order to perform its role under section 2(a)(41). However, ASR 113 and ASR 118 stated that the board should choose the methods used to arrive at fair value and continuously review the appropriateness of such methods.¹⁶⁰ In addition, the Commission stated that boards should consider all appropriate factors relevant to the fair value of securities for which market quotations are not readily available.¹⁶¹ Finally, the Commission stated that whenever technical assistance is requested from individuals who are not directors, the findings of such individuals must be carefully reviewed by the directors in order to satisfy themselves that the resulting valuations are fair.¹⁶² The 2014 Money Market Fund Release stated that funds “may consider evaluated prices from third-party pricing services, which may take into account these inputs as well as prices quoted from dealers that make markets in these instruments and financial models.”¹⁶³ The 2014 Money Market Fund Release also stated that “evaluated prices provided

¹⁵⁹ See *supra* footnotes 1, 12, 14, and 26. See also Section I for a discussion of other aspects of funds’ regulatory framework that are related to boards’ fair value role (*e.g.*, the Sarbanes-Oxley Act and ASC Topic 820).

¹⁶⁰ See *supra* footnote 14.

¹⁶¹ See *supra* footnote 15.

¹⁶² ASR 118 *supra* footnote 16.

¹⁶³ 2014 Money Market Fund Release, *supra* footnote 14.

by pricing services are not, by themselves, ‘readily available’ market quotations or fair values ‘as determined in good faith by the board of directors’ as required under the Investment Company Act.”¹⁶⁴ In addition, the Commission discussed in that release the factors that the fund’s board of directors may want to consider “before deciding to use evaluated prices from a pricing service to assist it in determining the fair values of a fund’s portfolio securities.”¹⁶⁵

Finally, the Compliance Rules Adopting Release stated the Commission’s view that rule 38a-1 requires compliance policies and procedures with respect to fair value.¹⁶⁶

2. *Current practices*

Our understanding of boards’ current fair value practices is based on fund disclosures, staff discussions with industry representatives, staff’s experience, and review of relevant industry publications and academic papers.¹⁶⁷ We expect that fund’s policies and procedures generally reflect their fair value practices.¹⁶⁸ We discuss below our understanding of current practices but acknowledge that practices may vary across funds and through time. We lack detailed data on the fair value practices of each individual fund and fund board, but, based on available inputs, we preliminarily believe that many of the requirements of the proposed rule are generally similar to

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ Compliance Rules Adopting Release, *supra* footnote 26, at 74718.

¹⁶⁷ *See, e.g.*, Investment Company Institute, Independent Directors Council, ICI Mutual Insurance Company, The Role of the Board, Spring 2005 (“ICI and IDC Report”); K&L Gates, Mutual Fund Valuation and Liquidity Procedures, 2013 (“K&L Report”); K&L Gates, Mutual Fund Pricing and Fair Valuation, 2016; MFDF Valuation Report, *see supra* footnote 97.

¹⁶⁸ *See, e.g.*, ICI and IDC Report, *supra* footnote 167, at 6-7.

current practice. We request data and other information on current fund practices in Section III.E below.¹⁶⁹

Fair Value Calculation. Most fund boards do not play a day-to-day role in the pricing of fund investments.¹⁷⁰ Typically, an investment adviser to the fund or other service providers perform the actual day-to-day fair value calculations.¹⁷¹ In addition to performing day-to-day calculations, investment advisers also typically assist the board in developing the fund’s fair value methodologies.¹⁷²

Fair Value Practices—Assess and manage risks. It is our understanding that boards play an important role in identifying and managing the fund’s valuation risks.¹⁷³ Examples of valuation risks that funds often address include changes in market liquidity, reliance on a single source for pricing data, reliability of data obtained from pricing services for securities that are not traded on exchanges, reliability of data provided by credit rating agencies, use of internal

¹⁶⁹ Funds have discretion in the type of disclosures they provide regarding their fair value determinations. Our review of N-1A, 485APOS, 485BPOS, N-2, and POS 8C Forms filed with the Commission between January 1, 2019 and December 31, 2019 showed that only 13% of the open-end funds and closed-end funds disclose information related to board’s fair value practices, out of which 37% explicitly state that the investment adviser assists the board in the fair value determinations. Nevertheless, the results of our review should be interpreted with caution because funds’ disclosures of fair value practices are unstructured and results may be sensitive to the algorithm used to identify those disclosures.

¹⁷⁰ See, e.g., Investment Company Institute, Independent Directors Council, ICI Mutual Insurance Company, An Introduction to Fair Valuation, Spring 2005 (“ICI Fair Valuation Report”), at 7. Nevertheless, “[t]here may be circumstances at a particular fund group that leads a board and adviser to determine that it is desirable for an independent director to be involved in day-to-day decision-making, whether as part of the adviser’s valuation committee or by reviewing and ratifying the committee’s decisions daily.” See MFDF Valuation Report, *supra* footnote 97, at 9.

¹⁷¹ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 4.

¹⁷² See, e.g., K&L Report, *supra* footnote 167, at 14; MFDF Valuation Report, *supra* footnote 97, at 11.

¹⁷³ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 6-8; Deloitte Insights, 2019. Fair valuation pricing survey, 17th edition, executive summary (“Deloitte Survey”), at 10. We lack information on how the Deloitte survey sample was constructed or how the survey data was collected and so we cannot speak to the representativeness of the sample or the unbiasedness of the survey responses. Nevertheless, the results of the survey are largely consistent with the Commission staff’s experience and in line with practices as described in prior Commission staff’s letters. See, e.g., staff letters in Section II.E.

information provided by portfolio managers to estimate fair values, use of internally developed models to value securities, extensive use of matrix pricing, the process surrounding the adviser's price overrides, timely identification of material events, and valuation risks arising from new investments.¹⁷⁴ Funds' valuation practices generally focus on mitigating potential conflicts of interest of the investment adviser as well as conflicts of interest of other parties that assist the board with fair value determinations (e.g., portfolio managers).¹⁷⁵ In particular, some investment advisers currently have in place processes to address potential conflicts of interest when portfolio management personnel provides input regarding valuation for a fund.¹⁷⁶

Valuation risks can change with changes in market conditions and changes in fund investments. Hence, funds may periodically review any previously-identified valuation risks.¹⁷⁷ Some boards meet with the fund's chief risk officer or members of the risk committee on a periodic basis to discuss the valuation of the portfolio securities as part of the assessment and management of previously identified risks.¹⁷⁸

Fair Value Practices—Establish fair value methodologies. Further, it is our understanding that funds that invest in securities that are fair valued have in place written

¹⁷⁴ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 6-8.

¹⁷⁵ According to a Deloitte survey, "22 percent of survey participants noted that their boards seek to identify areas in the valuation process where there might be a conflict of interest and provide oversight relative to these conflicts." See Deloitte Survey, *supra* footnote 173, at 10. The cited statistic does not imply that the remaining funds do not have policies in place to manage conflicts of interest of investment advisers but it means that any such policies may not be valuation specific.

¹⁷⁶ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 9.

¹⁷⁷ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 8.

¹⁷⁸ According to a Deloitte Survey, 34% of survey participants reported that the board or one of its subcommittees met with the chief risk officer or members of the risk committee to discuss valuation matters. See Deloitte Survey, *supra* footnote 173, at 10.

policies and procedures that detail the methodologies used when calculating fair values.¹⁷⁹ The methodologies often establish a suggested ranking of the pricing sources that an adviser should use when valuing securities, and different rankings can be established for different types of securities.¹⁸⁰ Many funds periodically review the appropriateness and accuracy of the methodologies used in valuing securities and make any necessary adjustments.¹⁸¹ Further, funds generally monitor the circumstances that may necessitate the use of fair values.¹⁸² For example, many funds establish triggering mechanisms in their policies and procedures to monitor circumstances that require the use of fair value methodologies, and third-party pricing services may be used to identify those triggering events.¹⁸³

Fair Value Practices—Test fair value methodologies. We understand that funds generally test the appropriateness and accuracy of the internally selected methodologies used to value securities. Funds may utilize methods such as back-testing to review the appropriateness and accuracy of the methodologies used.¹⁸⁴ We understand that many funds use systems to

¹⁷⁹ See, e.g., ICI and IDC Report, *supra* footnote 167, at 6-7; MFDF Valuation Report, *supra* footnote 97, at 5.

¹⁸⁰ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 5.

¹⁸¹ According to the Deloitte survey, 72% of survey participants performed periodic reviews of valuation models relating to private equity investments to determine the appropriateness and accuracy relative to the investment being valued, and 56% of participants reported that the valuation models used for private equity investments are explicitly subject to internal control policies and procedures. According to the same survey, 63% of survey participants made a change or revision to their valuation policies over the last year. See Deloitte Survey, *supra* footnote 173, p. 9 and 14.

¹⁸² See, e.g., MFDF Valuation Report, *supra* footnote 97, at 5.

¹⁸³ See, e.g., ICI and IDC Report, *supra* footnote 167, at 6-7 and 10-11; MFDF Valuation Report, *supra* footnote 97, at 5.

¹⁸⁴ See, e.g., ICI Fair Valuation Report, *supra* footnote 170, at 17-18.

identify security valuations that may require additional attention, such as security prices that have not changed over a period of time and changes in prices beyond a certain threshold.¹⁸⁵

Fair Value Practices—Identify responsibilities. Based on our understanding of current industry practices, we believe that funds generally allocate fair value functions,¹⁸⁶ which may be reflected in a written charter or the fund’s valuation policies and procedures.¹⁸⁷ As discussed above, an investment adviser to the fund assists the board with the day-to-day fair-value process. This allocation of valuation functions can help boards understand and monitor the level of involvement of portfolio managers in the valuation process. Portfolio managers can provide valuable inputs to the valuation of fund securities, but they are subject to conflicts of interest. Some boards create separate valuation committees with clearly established functions that help the board provide oversight of the investment advisers’ valuation practices.¹⁸⁸ If used, the structure of the valuation committees can differ across funds. Finally, fund policies and procedures may include “escalation procedures” that describe the circumstances under which certain investment adviser personnel or board members should be notified when fair value issues arise that are not addressed in existing fair value policies and procedures.¹⁸⁹

Fair Value Practices—Evaluate Pricing Services. We understand that funds frequently use third-party pricing service providers to assist in determining fair values.¹⁹⁰ Before engaging

¹⁸⁵ See, e.g., ICI and IDC Report, *supra* footnote 167, at 6-7.

¹⁸⁶ See generally MFDF Valuation Report, *supra* footnote 97, at 9; ICI and IDC Report, *supra* footnote 167, at 8-10.

¹⁸⁷ See, e.g., ICI and IDC Report, *supra* footnote 167, at 10.

¹⁸⁸ See, e.g., ICI and IDC Report, *supra* footnote 167, at 8-10.

¹⁸⁹ See, e.g., ICI and IDC Report, *supra* footnote 167, at 7.

¹⁹⁰ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 10; ICI and IDC Report, *supra* footnote 167, at 10-11.

a pricing service, boards may review background information on the vendor, such as the vendor's operations and internal testing procedures, emergency business continuity plans, and methodologies and information used to form its recommended valuations.¹⁹¹ Boards may develop an understanding of the circumstances in which third-party pricing services would provide assistance in securities valuation.¹⁹² In reviewing the performance of these pricing services, boards also may seek input from the fund's adviser or the pricing service itself, including probing whether the investment adviser performed adequate due diligence when selecting the service.¹⁹³ In particular, boards may consider whether the adviser tests prices received from pricing services against subsequent sales or open prices, whether the pricing services are periodically reviewed, and to what extent the pricing service considers adviser input. Funds may establish procedures for ongoing monitoring of the pricing services—including pricing service's presentations to the board, investment adviser's due diligence, and on-site visits to the pricing service—to determine whether the pricing service continues to have competence in valuing particular securities and maintains an adequate control environment.¹⁹⁴ Further, boards may seek to understand the circumstances under which the adviser may override the prices obtained by the pricing service provider.¹⁹⁵

¹⁹¹ See, e.g., ICI and IDC Report, *supra* footnote 167, at 11.

¹⁹² See, e.g., MFDF Valuation Report, *supra* footnote 97, at 10.

¹⁹³ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 11.

¹⁹⁴ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 11.

¹⁹⁵ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 10-11.

Board Reporting. As part of their current fair value practices, boards may review on a periodic basis reports regarding the fair value of fund securities.¹⁹⁶ Many boards review fair value determinations quarterly but some boards review the determinations more or less frequently depending on the type of fund securities and the market conditions.¹⁹⁷ Boards also may have ad-hoc discussions on valuation matters outside of their regular meetings.¹⁹⁸ Boards may consider the information they want in valuation reports, and, in some circumstances, a board member may play an active role in shaping the content of the valuation reports given to the board.¹⁹⁹ The content of reports the boards receive depends on the type of fund and fund investments.²⁰⁰ The type of general information that the boards may receive include a summary of back-testing data and an analysis of the impact of fair values on the fund's NAV.²⁰¹ The reports also may include more specific information about securities that are more difficult to value, such as the fair values assigned to each security, the size of the holding, the effect of the fair value on the fund's NAV, and the rationale for the decision to fair value.²⁰² Some board reports may also include security-specific information in cases where investment advisers

¹⁹⁶ See, e.g., ICI and IDC Report, *supra* footnote 167, at 12-13.

¹⁹⁷ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 10. See also Deloitte Survey, *supra* footnote 173, at 10, stating that 26% of the participants mentioned that the board held a valuation discussion in the prior 12 months with management outside of a regularly scheduled meeting to address a valuation matter or question.

¹⁹⁸ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 14.

¹⁹⁹ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 14.

²⁰⁰ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 14.

²⁰¹ See, e.g., ICI and IDC Report, *supra* footnote 167, at 12.

²⁰² See, e.g., ICI and IDC Report, *supra* footnote 167, at 12-13.

override prices provided by pricing services.²⁰³ Finally, some funds also include in board reports the minutes of, or summary memoranda and other written documentation from, valuation committee meetings held during the prior period.²⁰⁴

Valuation reports may vary depending on the volume and complexity of fair value determinations.²⁰⁵ For example, some boards require a case-by-case review of each asset that received fair value, whereas other boards require the adviser to provide a report on an asset that was assigned a fair value and this report is intended to provide a sample of the methodology that is used by the investment adviser.²⁰⁶

Recordkeeping. It is our understanding that most funds currently retain records related to fair value determinations as required by section 31 and the rules thereunder of the Investment Company Act. These records generally include identifying information for each portfolio security, data used for pricing, and any other information related to price determinations and fund valuation policies and procedures.

3. *Affected parties*

The proposed rule would affect all funds that invest in securities that must be fair valued under the Act, those funds' boards of directors, investment advisers, and investors. Table 1 below presents descriptive statistics for the funds that could be affected by the proposed rule. As of January 2020, there were 13,733 registered investment companies: (i) 12,379 open-end funds;

²⁰³ See, e.g., ICI and IDC Report, *supra* footnote 167, at 13. See also Deloitte Survey, *supra* footnote 173, at 10, noting that 74% of the participants in the 2019 survey reported that their boards receive price challenge information as part of the valuation reports.

²⁰⁴ See, e.g., ICI and IDC Report, *supra* footnote 167, at 13.

²⁰⁵ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 14.

²⁰⁶ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 14.

(ii) 666 closed-end funds; (iii) 674 UITs; and (iv) 14 variable annuity separate accounts registered as management companies.²⁰⁷ As of the same date, (i) open-end funds held total net assets of \$28,184 billion; (ii) closed-end funds held total net assets of \$301 billion; (iii) UITs held total net assets of \$1,883 billion; and (iv) variable annuity separate accounts registered as management companies held total net assets of \$234 billion. As of September 2019, there were 98 BDCs with \$64 billion in total net assets.²⁰⁸ Not all funds hold investments that must be fair valued under the Act. In addition, for those funds that hold investments that must be fair valued under the Act, the extent of those investments varies. Hence, the proposed rule would affect only a subset of the funds listed in Table 1 below.

²⁰⁷ We estimate the number of registered investment companies by reviewing the most recent filings of Forms N-CEN filed with the Commission as of January 2020. Open-end funds are series of trusts registered on Form N-1A. Closed-end funds are trusts registered on Form N-2. UITs are variable annuity separate accounts organized as UITs registered on Form N-4, variable life insurance separate accounts organized as UITs registered on Form N-6, or series, or classes of series, of trusts registered on Form N-8B-2. Separate accounts registered as management companies are trusts registered on Form N-3.

²⁰⁸ Estimates of the number of BDCs and their net assets are based on a staff analysis of Form 10-K and Form 10-Q filings as of September 2019, which are the most recent available filings. Our estimates include BDCs that may be delinquent or have filed extensions for their filings, and they exclude 8 wholly-owned subsidiaries of other BDCs and feeder BDCs in master-feeder structures.

Table 1: Descriptive statistics for funds

	Number of funds (1)	Total Net Assets (in billion \$) (2)
Open-end funds	12,379	28,184
Closed-end funds	666	301
UITs	674	1,883
Management company separate accounts	14	234
BDCs	98	64
Total	13,831	30,666

Sources: Form 10-K; Form 10-Q; Form N-CEN

To understand the extent of current boards’ involvement in the valuation of funds’ investments and the extent to which the proposed rule would affect funds’ operations, we examine funds’ investments under the U.S. GAAP fair value hierarchy.²⁰⁹ For purposes of this economic analysis, we treat investments that are valued using Level 1 inputs as investments for which readily available market quotations would be available, and investments valued using Level 2 and 3 inputs as investments that would be fair valued in good faith by the fund’s board of directors.²¹⁰ We therefore expect that funds that hold more securities that are measured using Level 2 and 3 inputs would be more affected by the proposed rule than funds that do not invest in these kinds of securities or hold fewer of them.

²⁰⁹ According to ASC 820, assets and liabilities are classified as using Level 1, Level 2, or Level 3 inputs. Level 1 inputs are “quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can assess at the measurement date.” Level 2 inputs are “inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.” Level 3 inputs are “unobservable inputs for the asset and liability.” *See* Financial Accounting Standards Board, Fair Value Measurement (Topic 820).

²¹⁰ *See* proposed rule 2a-5(c). *See also supra* Section II.C.

Table 2 provides descriptive statistics on funds' investments in securities measured based on Levels 1, 2, and 3 inputs using Form N-PORT data as of January 2020.²¹¹ As Table 2 shows, there are 11,436 funds with \$24,338 billion in net assets that filed Form N-PORT.²¹² About 63% of fund assets are valued using Level 1 inputs. Nevertheless, the average percentage of securities valued using Level 1 inputs varies with the type of fund, ranging from 26% for closed-end funds to 99% for ETFs registered as UITs. About 33% of fund assets are valued using Level 2 inputs,

²¹¹ UITs (other than the ETFs registered as UITs) and BDCs do not file Form N-PORT, and thus are excluded from Table 2.

We estimate the statistics in Table 2 by reviewing the most recent filings of Forms N-PORT filed with the Commission as of January 2020. The average ratio of securities by fair value hierarchy (*i.e.*, Columns 3 to 6 in Table 2) is retrieved from Item C.8 of Form N-PORT. Our analysis excludes funds with non-positive net assets and funds with total assets less than net assets because these observations are likely data errors. The Average Level 1, Level 2, and Level 3 Inputs is the average ratio of Level 1, Level 2, or Level 3 long positions divided by the fund's total gross assets across all funds within each fund category. Open-end funds are series of trusts registered on Form N-1A. Closed-end funds are trusts registered on Form N-2. ETFs registered as UITs are series, or classes of series, of trusts registered on Form S-6. Separate accounts registered as management companies are trusts registered on Form N-3.

The last row in Table 2 represents the sum of the previous rows within the same column for Columns 1 and 2, and it represents the asset-weighted average of the previous rows within the same column for columns 3 to 6.

²¹² The number of open-end funds, closed-end funds, ETFs registered as UITs, and separate accounts registered as management companies that filed Form N-PORT (*i.e.*, 11,436 in Table 2) is smaller than the number of open-end funds, closed-end funds, ETFs registered as UITs, and separate accounts registered as management companies that filed Form N-CEN (*i.e.*, 13,067 in Table 1) because, as of the N-PORT data collection date, N-PORT only covered large fund groups. Large fund groups are funds that together with other investment companies in the same "group of related investment companies" have net assets of \$1 billion or more as of the end of the most recent fiscal year of the fund. Filing Form N-PORT will begin in April 2020 for small fund groups. *See* Amendments to the Timing Requirements for Filing Reports on Form N-PORT, Interim Final Rule, Release No. IC-33384; File No. S7-02-19. Nevertheless, large fund groups represent 84% of all open-end funds, closed-end funds, ETFs registered as UITs, and separate accounts registered as management companies in terms of total net assets (84% = \$24,338 billion total net assets in Table 2 / \$29,093 billion total net assets for open-end funds, closed-end funds, ETFs registered as UITs, and variable annuity separate accounts registered as management companies in Table 1).

Total net assets in Form N-CEN also may be different than total net assets in Form N-PORT because Form N-CEN reports average net assets estimated over the reporting period while Form N-PORT reports point-in-time net assets as of the reporting date.

and this percentage varies with the type of fund. Only a small percentage of fund assets are valued using Level 3 inputs.²¹³

Finally, untabulated analysis shows that 28% of the funds only report securities valued using Level 1 inputs.²¹⁴ Consequently, we estimate that approximately 9,986 funds could be affected by the proposal, of which 9,501 are not UITs.²¹⁵ Nevertheless, even though the proposed rule would be relevant for all funds with investments valued using non-Level 1 inputs, not all of those funds would have to materially change their practices under the proposed rule.

²¹³ Securities that are valued at NAV, and thus do not have a level associated with them, are classified as “N/A” in Form N-PORT. These investments have no level under the U.S. GAAP fair value hierarchy and for purposes of this analysis we assume they are securities for which there are no readily available market quotations. Nevertheless, the valuation of those securities arguably requires less effort than the valuation of securities valued using Level 2 and 3 inputs because funds’ NAVs are easily obtainable. About 1% of the fund assets are classified as “N/A” securities.

The sum of the average using Level 1, 2, 3, and “N/A” within each fund category may not sum up to one hundred percent due to rounding error.

²¹⁴ $28\% = (3,209 \text{ open-end funds with securities valued using only Level 1 inputs that filed Form N-PORT} + 29 \text{ closed-end funds with securities valued using only Level 1 inputs that filed Form N-PORT} + 5 \text{ ETFs registered as UITs with securities valued using only Level 1 inputs that filed Form N-PORT} + 3 \text{ variable annuity separate accounts registered as management companies with securities valued using only Level 1 inputs that filed Form N-PORT}) / 11,436 \text{ funds that filed Form N-PORT}$. See *supra* footnote 211.

²¹⁵ $9,986 \text{ funds} = 13,733 \text{ registered investment companies that filed Form N-CEN from Table 1 above} - 3,845 \text{ registered investment companies that filed Form N-CEN and are estimated to hold securities valued using only Level 1 inputs} + 98 \text{ BDCs from Table 1 above}$. $3,845 = 28\% * 13,733 \text{ registered investment companies that filed Form N-CEN from Table 1 above}$. See *supra* footnote 214 for the estimation of the 28%.

This calculation assumes that the distribution of securities valued using Level 1 inputs for registered investment companies that filed Form N-PORT is similar to the distribution of securities valued using Level 1 inputs for registered investment companies that filed Form N-CEN. This calculation also assumes that all 98 BDCs in our sample hold a non-zero amount of securities valued using Level 2 and Level 3 inputs because BDCs are required to invest at least 70% of their assets in private or public U.S. firms with market values of less than \$250 million, and these investments usually are securities valued using Level 2 or Level 3 inputs. See 15 U.S.C. 80a-54(a).

Under the proposed rule 2a-5(d), if the fund is a unit investment trust, the fund’s trustee must carry out the requirements related to fair value determinations. Hence, UITs would not bear one-time costs associated with oversight and reporting (see proposed rule 2a-5(b)) because the trustees of UITs would perform all fair value determinations. $9,501 = 9,986 \text{ affected funds} - 485 \text{ affected UITs}$. $485 = 674 \text{ UITs that filed Form N-CEN} * (1 - 28\% \text{ of funds that only report securities valued using Level 1 inputs})$.

As discussed in more detail below, the effects of the proposed rule would depend on the extent to which funds' current practices differ from the requirements of the proposed rule.

Table 2: Descriptive statistics for funds by ASC 820 fair value hierarchy

	Number of funds (1)	Total Net Assets (in billion \$) (2)	Average Level 1 Inputs (3)	Average Level 2 Inputs (4)	Average Level 3 Inputs (5)	Average "N/A" Inputs (6)
Open-end funds	10,841	23,429	63%	33%	0.2%	1%
Closed-end funds	577	303	26%	60%	4%	9%
ETFs registered as UITs	5	389	99%	0%	0%	0%
Management company separate accounts	13	217	73%	26%	0%	0%
Total / Average	11,436	24,338	63%	33%	0%	1%

Source: Form N-PORT

As of January 2020, there were 1,921 investment advisers that provide portfolio management services to funds and these investment advisers managed assets equal to \$28,517 billion.²¹⁶

Finally, as of December 2018, there were 57.2 million U.S. households and 101.6 million individuals owning U.S. registered investment companies that could be affected by the proposed rule.²¹⁷

C. Benefits and Costs and Effects on Efficiency, Competition, and Capital Formation of Proposed Rule

1. General economic considerations

²¹⁶ Based on Item 5.D. of Forms ADV filed with the Commission as of January 2020.

²¹⁷ Investment Company Institute, 2019 Fact Book: A Review of Trends and Activities in the Investment Company Industry, available at https://www.ici.org/pdf/2019_factbook.pdf, accessed on December 5, 2019.

Unbiased and accurate valuation of fund investments is important because it affects the prices at which fund securities are purchased or sold in the secondary market and also affects the prices at which fund securities are purchased or redeemed in the primary market. The valuation of fund securities is also important because it can affect funds' fee and performance calculations, and also can affect funds' compliance with regulatory requirements. Finally, properly valuing a fund's investments is a critical component of the accounting and financial reporting for investment companies.²¹⁸

Under the Investment Company Act, whenever market quotations are readily available, these market quotations must be used to determine fund asset values.²¹⁹ Whenever market quotations are not readily available, the value must be the fair value of fund holdings as determined by the board in good faith. This fair value determination can involve the use of complex methodologies, multiple data sources, and various assumptions. Today, we understand that, typically, boards determine the methodologies used to fair value fund investments, but rely on the adviser for the day-to-day calculation of fair values.²²⁰

Nevertheless, fund investment advisers have conflicts of interest, which could bias the fair value process.²²¹ In particular, investment advisers have incentives to inflate fund asset

²¹⁸ See Section I above for more discussion on the importance of accurate and unbiased valuation of fund securities.

²¹⁹ See section 2(a)(41) and rule 2a-4.

²²⁰ See, e.g., MFDF Valuation Report, *supra* footnote 97, at 2.

²²¹ Some academic literature suggests that fund fair values are not always measured in an accurate and unbiased way. See, e.g., Vikas Agarwal et al., Private Company Valuations by Mutual Funds, (Working Paper, 2019) available at <https://ssrn.com/abstract=3066449>; Rahul Bhargava et al., Exploiting International Stock Market Correlations with Open-End International Mutual Funds, 25 J. Bus. Fin. & Acct. 765 (1998); Scott Cederburg & Neal Stoughton, Discretionary NAVs, (Working Paper, 2019) available at https://www.wu.ac.at/fileadmin/wu/d/i/finance/BBS-Papers/SS2019/20190515_STOUGHTON.pdf; John M. R. Chalmers et al., On the Perils of Financial

values (or deflate fund liability values) because they typically receive a management fee that is calculated as a percentage of the value of assets under management.²²² Relatedly, investment advisers have incentives to inflate fund asset values because investors tend to invest more in funds that performed well in recent periods, which would increase assets under management and ultimately increase investment advisers' compensation.²²³ Investment advisers also have incentives to mismeasure fund investments in a way that would result in smooth reported fund performance over time to lower the funds' perceived risk.²²⁴ Finally, investment advisers may mismeasure fund investments as a result of expending less effort to value assets than the effort required to ensure accurate and unbiased valuations.²²⁵

Intermediaries Setting Security Prices: The Mutual Fund Wild Card Option, 56 J. Fin. 2209 (2001); Nandini Chandar & Robert Bricker, Incentives, Discretion, and Asset Valuation in Closed-End Mutual Funds, 40 J. Acct. Res., 1037 (2002) ("Chandar and Bricker 2002"); Jaewon Choi et al., Sitting Bucks: Zero Returns in Fixed Income Funds, (Working Paper, 2019) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244862; Cici et al. 2011, *supra* footnote 7; [Vladimir Atanasov et al., Mismarking Fraud in Mutual Funds, \(Working Paper, 2019\) available at \[http://www.fmaconferences.org/Glasgow/Papers/Fraud_in_OpenEndMutualFunds_2018_1126.pdf\]\(http://www.fmaconferences.org/Glasgow/Papers/Fraud_in_OpenEndMutualFunds_2018_1126.pdf\)](#).

²²² *See, e.g.*, Joseph Golec, Regulation and the Rise in Asset-Based Mutual Fund Management Fees, 26 J. Fin. Res. 19 (2003) for evidence on the percentage of mutual funds that use asset-based management fees.

In addition to explicit contracts that link investment advisers' compensation to fund size, there may be implicit contracts that provide incentives to investment advisers to mismeasure fund investments. For example, investment advisers may mismeasure fund investments to meet or beat certain benchmarks. *See, e.g.*, Chandar and Bricker 2002, *supra* footnote 221.

²²³ *See, e.g.*, Judith Chevalier & Glenn Ellison, Risk Taking by Mutual Funds as a Response to Incentives, 105 J. Pol. Econ. 1167 (1997); Erik R. Sirri & Peter Tufano, Costly Search and Mutual Fund Flows, 53 J. Fin. 53, 1589 (1998).

Portfolio managers also have incentives to inflate fund asset values and thus increase fund performance because fund performance is positively related to the portfolio managers' compensation and negatively related to the probability that a portfolio manager will be terminated. *See, e.g.*, Judith Chevalier & Glenn Ellison, Career Concerns of Mutual Fund Managers, 114 Q.J. Econ. 389 (1999); Linlin Ma et al., Portfolio Manager Compensation in the U.S. Mutual Fund Industry, 74 J. Fin. 587 (2018).

²²⁴ *See, e.g.*, Cici et al. 2011, *supra* footnote 7.

²²⁵ Investment advisers may have incentives to underinvest in effort (or "shirk") because they do not internalize the benefits accruing to the fund board of directors and fund investors from the expenditure of effort to estimate accurate and unbiased fair values. *See, e.g.*, David Brown & Shaun Davies, Moral hazard in asset management, 125 J. Fin. Econ. 311 ("Brown and Davies 2017").

The degree of conflicts of interest may vary across funds. In particular, investment advisers' incentives to misreport fund investments may be more pronounced for funds that face higher competition to attract new investors and for actively managed funds that face higher demands from investors to beat certain benchmarks. Relatedly, investment advisers' incentives to underinvest in effort may be higher for funds whose performance is more difficult to measure and evaluate, and thus investment advisers' performance is also more difficult to measure and evaluate (*e.g.*, funds that hold complex investments).²²⁶ Boards of directors currently serve as a check on the conflicts of interest of the adviser and the other service providers involved in the calculations of fair values.²²⁷

As discussed in Section I above, since ASR 113 and 118 were first issued roughly fifty years ago, funds' investment practices have changed, the regulatory framework under which funds operate has evolved, and there have been significant advances in technology and communication. The proposed rule would provide an updated framework for valuation under the Investment Company Act that is more suitable to current market realities. The proposed rule retains the important safeguard of board oversight of fair value determinations, while making more efficient use of boards' time and expertise and recognizing the important role of fund investment advisers in the fair value determination process.

The proposed rule differs from the current regulatory framework and funds' current practices in the following ways. First, under the current regulatory framework, funds have flexibility to determine their fair value policies and procedures, reporting, and recordkeeping

²²⁶ See, *e.g.*, Brown and Davies 2017, *supra* footnote 225.

²²⁷ See *supra* footnote 175.

requirements. The proposed rule would differ from the current regulatory framework because it would mandate more specific fair value practices, policies and procedures, reporting, and recordkeeping requirements and those requirements would be explicitly imposed on funds and performed by boards or advisers.²²⁸ In particular, the proposed rule would prescribe more specific elements that fair value policies and procedures adopted under the rule must address as compared to the current framework under rule 38a-1.²²⁹ For example, in addition to the fair value policies and procedures that are required pursuant to rule 38a-1, the proposed rule would require the written policies and procedures to be reasonably designed to address, in the context of methodologies, the selection and application of a methodology in a consistent manner, the specification of which methodologies apply to new types of fund investments in which a fund intends to invest, and testing of the appropriateness and accuracy of the selected methodology, including identifying the testing methods and minimum frequency of testing.²³⁰ In addition, unlike under proposed rule 2a-5, there is currently no requirement regarding the frequency and content of periodic valuation reports and the promptness and content of ad hoc valuation reports the board receives. The proposed rule would require quarterly periodic reporting as well as prompt reporting no later than three business days after the adviser becomes aware of certain matters relevant to fair value. Also, the proposed rule specifies the matters that the adviser must, at a minimum, cover in its periodic reporting to the board. Finally, rule 38a-1 requires the

²²⁸ See proposed rule 2a-5(a) and (b).

²²⁹ Compare proposed rule 2a-5(a)(1)-(5) with Compliance Rules Adopting Release, *supra* footnote 26. See also *supra* footnote 28 and accompanying text.

²³⁰ See proposed rule 2a-5(a)(2), (3), and (5).

maintenance of records related to the fund's compliance policies and procedures for five years.²³¹ The proposed rule would apply the same retention period, but it would require the maintenance of records that are specific to fair value determinations.²³² Further, the proposed rule would require the adviser to maintain copies of the reports and other information provided to the board under the rule whenever the board assigns the determination of fair value to an investment adviser to the fund.

Second, we understand that funds' current practices regarding their fair value policies and procedures, reporting, and recordkeeping are generally consistent with the requirements of the proposed rule. Nevertheless, there is variation in funds' fair value practices, and the practices of certain funds may be more or less extensive and thorough than the requirements of the proposed rule. Consequently, the proposed rule would impose uniform minimum requirements on all affected funds related to their fair value policies and procedures, reporting, and recordkeeping.

Third, under the current regulatory framework, boards choose the methodologies used to determine the fair value of the funds' investments, continuously review the appropriateness of such methods, consider all appropriate factors relevant to the fair value of securities for which market quotations are not readily available, and carefully review the findings of individuals that are not directors whenever technical assistance is requested from those individuals.²³³ In addition, it is our understanding that some boards currently ratify all or some of the fair value calculations of an investment adviser to the fund. Under the proposed rule, boards may assign a fair value determination to an investment adviser of the fund, who would carry out all of those

²³¹ See rule 38a-1(d). See also *supra* footnote 72.

²³² See proposed rule 2a-5(a)(6) and (b)(3).

²³³ See *supra* Section III.B.1.

functions.²³⁴ It is our understanding that funds' investment advisers already assist the board with respect to many of those functions subject to the board's oversight.

Under the proposed rule, fund boards would have discretion to assign the fair value determination to an investment adviser to the fund, who would carry out all of the functions that would be required under the rule. When deciding whether to assign fair value determinations to an investment adviser to the fund, a board would consider certain trade-offs. In particular, fund boards' decisions to oversee investment advisers' fair value determinations instead of determining fair value themselves would depend on the amount of investments that must be fair valued, the nature and complexity of the valuation of those investments, the type of fund, the investment adviser's willingness to assume additional fair value responsibilities, and the fund's current practices. Boards of funds that hold more securities that must be fair valued and harder-to-value securities may be more likely to assign these fair value determinations to an adviser and oversee the process of determining fair value by the assigned adviser because investment advisers may be better suited to value certain investments. It may also depend on the type of fund. For example, a board of an open-end fund that must calculate NAVs on a daily basis may be more likely to assign to an investment adviser the determination of fair values (on which fund's NAV is based) than the board of a fund that calculates value less regularly. The decision to oversee investment advisers' fair value determinations would also depend on investment advisers' willingness to assume the assigned responsibilities. Such willingness would depend on investment advisers' valuation expertise and experience, whether the investment advisers have available resources to satisfy their new obligations, and the extent to which the investment

²³⁴

See proposed rule 2a-5(b).

advisers could pass through to the fund and its investors any higher costs associated with the increased responsibilities. Finally, a board's decision to assign responsibilities under the proposed rule would depend on the expected costs of compliance, which would ultimately depend on how different funds' current practices and policies and procedures are from the requirements of the proposed rule.

We lack detailed and representative information on funds' current fair value practices and we do not have visibility into boards' decision-making processes when seeking the investment advisers' assistance with fair value determinations.²³⁵ Further, boards' decision-making processes with respect to seeking the investment advisers' assistance with fair value determinations is complex. Hence, we are unable to accurately estimate the number of fund boards that would assign responsibilities to an adviser under the proposed rule instead of the boards making fair value determinations in good faith themselves. Nevertheless, we believe that most boards would assign these responsibilities to an investment adviser to the fund because the investment adviser has valuation experience and expertise and is involved with the fund's operations on a daily basis and, thus, may be better suited than the board to deal with fair value matters that arise on a daily basis. Further, advisers already provide significant assistance with the fair value determinations to the board of directors and so funds would not be required to significantly modify their operations if they choose to assign fair value determinations to an investment adviser to the fund under the proposed rule. As a result, for the purpose of our

²³⁵ The industry reports cited in Section III.B.2 above only provide qualitative information on certain aspects of funds' current practices. *See also supra* footnote 173 for a discussion of limitations of the Deloitte survey data. Finally, funds have discretion in the type of disclosures they provide regarding their fair value determinations. *See supra* footnote 169.

economic analysis, we assume that all funds that have some securities that would need to be fair valued would be affected parties.

We expect that the effects of the proposed rule could differ across funds. In particular, under the proposed rule, if the fund is a unit investment trust, the fund's trustee must carry out the fair value determinations.²³⁶ Hence, UITs would not bear any costs associated with oversight and reporting. We expect the effects of all other aspects of the rule to be similar for UITs and other funds. Further, the proposed rule would have larger effects on funds that currently do not utilize advisers in the fair value process but would choose under the proposed rule to assign the fair value determination of fund investments to an investment adviser to the fund. In addition, the proposed rule would also have a larger effect on funds for which a larger percentage of their investments do not have readily available market quotations because those funds would be required to determine the fair value of a larger percentage of their investments in compliance with the rule. The proposed rule would also have larger effects on funds whose current fair value policies and procedures, reporting, and recordkeeping requirements differ more from the proposed rule's requirements. The proposed rule could have a larger effect on smaller funds because of economies of scale in the adoption and implementation of the proposed rule's requirements. In particular, as discussed in detail in Section III.C.3 below, there are certain fixed costs associated with the implementation of the proposed rule's requirements, such as testing and preparing methodologies, policies and procedures, and training materials, and those fixed costs would be less burdensome for larger funds, who could spread those costs across a larger amount of assets under management. Finally, whenever the fair value determinations would be assigned

²³⁶ See proposed rule 2a-5(d).

to the fund's investment adviser, the requirement to reasonably segregate the investment adviser's process of making fair value determinations from the portfolio management could be more costly for smaller investment advisers than for larger ones. The reason is that smaller investment advisers could lack the staff and resources to segregate portfolio management personnel from those making fair value determinations as efficiently as larger advisers or might only be able to meet this requirement by hiring additional personnel.

We discuss the benefits and costs of the proposed rule as well as the effects on efficiency, competition, and capital formation in detail below.

2. *Benefits*

The proposed rule would mandate specific fair value functions, including written policies and procedures, reporting, and recordkeeping that funds would have to have in place to comply with the statute, and would define which securities are considered to have readily available market quotations under section 2(a)(41) of the Act. This increased specificity could reduce compliance costs in that funds may expend less effort and time to design policies and procedures, reporting, and recordkeeping under the proposed rule than trying to determine appropriate compliance under the statute alone.²³⁷ For funds whose current practices are more burdensome than the proposed rule's requirements, this increased specificity also could reduce compliance costs to the extent that funds might be less likely to put in place overly burdensome and

²³⁷ Any such benefits could be at least partially limited by the fact that mandating specific fair value functions for all funds could lead to the adoption of fair value functions that are appropriate for most but not all funds.

unnecessary policies and procedures, reporting, and recordkeeping to comply with the statute.²³⁸

Relatedly, the proposed rule and the rescission of existing no-action letters and guidance would increase certainty because funds would follow a single rule rather than following various no-action letters and guidance when determining fair values, which could ultimately reduce compliance costs.²³⁹ Lower costs of compliance for funds ultimately could benefit fund investors to the extent that any cost savings would be passed down to them in the form of lower fund operating expenses.

In addition, the proposed rule would benefit funds and their investors because it would allow boards to allocate more fair value responsibilities to an investment adviser to the fund, and thus could free board resources tied to valuation and redirect them to oversight or other matters in which board action may be more valuable.²⁴⁰ In particular, for funds whose boards of directors would assign the fair value determinations to an investment adviser to the fund, the boards would no longer be required to choose the methodologies used to determine the fair value of the funds' investments, continuously review the appropriateness of such methods, consider all appropriate factors relevant to the fair value of securities for which market quotations are not readily available, and carefully review the findings of individuals that are not directors whenever technical assistance is requested from those individuals. We lack detailed data on boards'

²³⁸ Nevertheless, we acknowledge that because the proposed rule is principles based, the possibility still exists that some funds may put in place additional policies and procedures, reporting, and recordkeeping that are not required by the proposed rule.

²³⁹ Academic literature provides evidence consistent with the idea that uncertainty has negative effects on investment and growth. *See, e.g.*, Nicholas Bloom et al., *Uncertainty and Investment Dynamics*, 74 *Rev. Econ. Stud.* 391 (2007); Nicholas Bloom, *The Impact of Uncertainty Shocks*, 77 *Econometrica*, 623 (2009); Scott R. Baker et al., *Measuring Economic Policy Uncertainty*, 131 *Q. J. Econ.* 1593 (2016).

²⁴⁰ This benefit would not accrue to UITs because under the proposed rule the trustees of UITs would carry out the requirements of the proposed rule. *See* proposed rule 2a-5(d).

current practices and so we are unable to estimate these cost savings but we request comment on this point in Section III.E. below.²⁴¹

Finally, the proposed rule would require all funds to adopt specific policies and procedures related to fair value determinations. In addition, whenever the board assigns the fair value determination relating to a fund investment to an investment adviser, the proposed rule would require the board's effective oversight of the investment adviser's conflicts of interest related to fair value determinations. To the extent that certain funds' fair value policies and procedures currently are less thorough than the policies and procedures of the proposed rule and certain boards' oversight of the investment advisers' conflicts of interest is less effective than under the proposed rule, the proposed rule could decrease the likelihood that fund investments would be inaccurately fair valued.²⁴² This is because the proposed rule could create a more robust valuation framework and could help to address any conflicts of interest of the investment adviser, which could result in more accurate and unbiased asset prices. Any such effects likely would be more pronounced for investors of funds that are not publicly traded (*e.g.*, open-end funds and BDCs) because there is no secondary market for the shares of those funds and fund investors can only trade at NAV, which is determined by the fund's fair value determinations. Nevertheless, this may not have a significant effect because it is our understanding that many funds currently have in place fair value practices that are similar to the proposed rule's requirements and boards oversee the investment adviser's assistance with fair value calculations.

3. *Costs*

²⁴¹ See *supra* footnote 235.

²⁴² See *supra* Section III.C.1. for a discussion related to investment advisers' conflicts of interest.

The proposed rule would impose one-time costs on funds and their investors.²⁴³ We expect that funds would incur one-time costs to review the proposed rule's requirements and modify, as necessary, their fair value practices, policies and procedures, and recordkeeping to comply with the proposed rule. Funds whose boards would assign the fair value determinations to the investment adviser would also incur one-time costs to review the proposed rule's requirements and modify their oversight and reporting procedures to comply with the rule. Even though we understand that most funds currently have in place practices related to fair value determinations, those practices differ across funds and also may differ from the proposed rule's requirements. In particular, the types of policies and procedures that funds have in place related to fair value determinations, the frequency and content of periodic board reporting, the promptness and content of ad hoc board reporting, and the extent and duration of recordkeeping may differ under the proposed rule compared to current practices.

Our staff estimates that the one-time incremental costs necessary to ensure compliance with the proposed rule would range from \$100,000 to \$600,000 per fund, depending on the current fair value practices of the fund.²⁴⁴ These estimated costs are attributable to the following

²⁴³ The proposed rule requires funds to evaluate any pricing services that assist funds with the fair value determinations. *See* proposed rule 2a-5(a)(4). To the extent that the proposed rule's requirements related to pricing services differ from funds' current practices, the proposed rule could have second-order effects on pricing services' operations because pricing services could adjust their operations to cater to their clients' new demands. Because we believe that funds' current practices are generally similar to the proposed rule's requirements related to the evaluation of pricing services, we believe that the proposed rule would not have significant effects on pricing services.

²⁴⁴ The one-time cost estimates used in the economic analysis may differ from the cost estimates in Section IV below because (i) the cost estimates in the economic analysis capture all costs associated with the proposed rule while the cost estimates in Section IV capture only costs related to information collection burdens and (ii) the cost estimates in the economic analysis capture incremental costs associated with the proposed rule while the cost estimates in Section IV capture total costs. Hence, the cost estimates in Section IV below serve as an upper bound of costs related to information collection burdens for funds that do not have in place currently any practices that are similar to the proposed rule's requirements.

activities: (i) reviewing the proposed rule's requirements; (ii) developing new (or modifying existing) policies and procedures, reporting, and recordkeeping requirements to align with the requirements of the proposed rule; (iii) integrating and implementing those policies and procedures, reporting, and recordkeeping requirements to the rest of the funds' activities; (iv) preparing new training materials and administering training sessions for staff in affected areas; and (v) independent board members consulting their independent counsel on whether fair value determinations should be assigned to the fund's investment adviser and how to set up appropriate policies and procedures, reporting, and recordkeeping requirements. We expect that the one-time incremental cost necessary to ensure compliance with the proposed rule would depend on the fund's current fair value practices and the amount and valuation complexity of fund investments that must be fair valued. In particular, the one-time costs would be closer to the lower end of the range for funds whose current practices are more similar to the requirements of the proposed rule and funds with fewer and easier-to-value fund investments. Further, the one-time costs would be closer to the lower end of the range for funds that belong to fund complexes because certain aspects of the one-time costs are fixed costs that could be spread across multiple funds in the case of fund complexes.

As discussed above, out of the 13,831 funds, we estimate that 9,986 would be affected the proposed rule, and thus incur the one-time costs associated with the proposed rule.²⁴⁵ We estimate that 70% of the one-time costs would be attributable to funds reviewing and updating the current practices and related policies and procedures to comply with the proposed rule's requirements; 15% of those costs would be attributable to funds reviewing and updating current

²⁴⁵

See supra footnote 215.

recordkeeping processes to align with the proposed rule's requirements; and the remaining 15% of those costs would be attributable to funds reviewing and updating the current board reporting processes to comply with the proposed rule's requirements. Hence, we estimate the aggregate one-time costs of the proposed rule to range between \$991.3 million and \$5.9 billion.²⁴⁶

For funds whose boards would assign the fair value determinations to the funds' investment advisers, those one-time costs would be borne by the investment adviser, and could be ultimately passed through to the fund shareholders in the form of higher management fees. For funds whose boards determine the fair values themselves, those one-time costs could be ultimately passed through to the fund shareholders in the form of higher operating expenses. We expect that the vast majority of the boards would assign fair value determinations relating to an investment adviser to the fund, and so the majority of the one-time costs would be borne by the fund's investment adviser, and ultimately could be passed through to the fund shareholders in the form of higher management fees.

The proposed rule also could impose ongoing costs on all funds that hold securities without readily available market quotations because those funds would be required to comply with the proposed rule's policies and procedures, reporting, and recordkeeping requirements. Nevertheless, we believe that funds' incremental ongoing costs associated with this aspect of the

²⁴⁶ 991.3 million = (485 UITs that would be affected by the proposed rule x \$100,000 minimum one-time costs of the proposed rule x 85%) + (9,501 open-end funds, closed-end funds, variable annuity separate accounts, and BDCs that would be affected by the proposed rule x \$100,000 minimum one-time costs of the proposed rule). 85% = 70% of the one-time costs attributable to reviewing fair value practices and policies and procedures + 15% of the one-time costs attributable to reviewing recordkeeping practices. *See supra* footnote 215.

5.9 billion = (485 UITs that would be affected by the proposed rule x \$600,000 maximum one-time costs of the proposed rule x 85%) + (9,501 open-end funds, closed-end funds, variable annuity separate accounts, and BDCs that would be affected by the proposed rule x \$600,000 maximum one-time costs of the proposed rule).

proposed rule would be limited to the extent that, as discussed in Section III.B.2. above, funds currently have in place practices, policies and procedures, reporting, and recordkeeping associated with fair value determinations that are similar to the proposed rule's requirements. Certain funds might put in place policies and procedures, reporting, and recordkeeping to comply with the proposed rule that are more costly than the funds' current practices, while other funds might set up policies and procedures, reporting, and recordkeeping as a result of the proposed rule that would result in lower ongoing costs than the costs of current practice. We acknowledge that funds whose practices, policies and procedures, reporting, and recordkeeping are less costly than the proposed rule's requirements would bear additional ongoing costs under the proposed rule. We lack detailed data on funds' fair value practices, policies and procedures, reporting, and recordkeeping, and so we are unable to estimate the net incremental ongoing costs of the proposed rule on funds, but we request comment on this topic in Section III.E. below.²⁴⁷

The proposed rule also would mandate more detailed and specific policies and procedures, reporting, and recordkeeping than the current regulatory framework, which could decrease funds' flexibility to design policies and procedures, reporting, and recordkeeping that better meet their preferences. Consequently, funds could bear costs to implement practices (*e.g.*, quarterly periodic reporting) that are incompatible with the way they would approach these matters absent rule 2a-5. Any such costs could be borne ultimately by fund investors in the form of higher operating expenses.

For funds whose boards would assign the fair value determinations to the funds' investment advisers, the proposed rule could impose additional ongoing costs associated with

²⁴⁷ See *supra* footnote 235.

boards' oversight of the investment adviser's fair value determinations and review of board reports. Nevertheless, we believe that funds' incremental ongoing costs associated with this aspect of the proposed rule would be limited to the extent that boards or funds currently have in place policies to ensure appropriate oversight of an investment adviser's assistance with fair value calculations and boards currently review periodic and ad-hoc reports related to fair value determinations prepared by the fund's investment adviser. Hence, we do not believe that this aspect of the proposed rule would impose any significant incremental ongoing costs on boards and fund investors compared to the ongoing costs under current practices.²⁴⁸ We acknowledge, however, that to the extent boards' current oversight of investment advisers' fair value calculations and boards' current practices with respect to review of valuation reports is inconsistent with the proposed rule's requirements, funds would bear ongoing costs to comply with the proposed rule.

Relatedly, to the extent that fair value determinations would be assigned to an investment adviser to the fund, such investment advisers would incur ongoing costs to satisfy their new fair value obligations. Those costs would be attributable to adopting and implementing policies and procedures, reporting, and recordkeeping to ensure compliance with the proposed rule's requirements. The magnitude of those costs would depend on how investment advisers' current practices compare to the requirements of the proposed rule. Investment advisers could demand higher fees as a compensation for the increased valuation responsibilities. Depending on the level of competition in the fund investment adviser industry, those higher fees could be passed

²⁴⁸ We do not believe that the proposed rule would result in cost savings associated with boards' involvement in the determination of fair values because we believe that boards would reallocate time and attention to overseeing the adviser's fair value determinations or other activities unrelated to fair valuing fund investments.

on to fund investors in the form of higher fund fees. We lack data to estimate any cost increases and the pass-through rate of those cost increases to fund investors but we request comment on this issue in Section III.E. below.

Finally, to the extent that the board would assign the fair value determinations relating to any or all of fund investments to the investment adviser, the proposed rule would provide the adviser—which has conflicting interests—a greater role in fair value determinations relative to current practices.²⁴⁹ Nevertheless, we believe that any impact from such conflicts would be limited because the proposed rule contains explicit requirements related to the identification, assessment, and management of any material conflicts of interest of the investment adviser, including the requirement to reasonably segregate the investment adviser’s process of making fair value determinations from the portfolio management, and funds currently have in place policies to manage conflicts of interest of investment advisers that may not be valuation specific.

4. *Effects on efficiency, competition, and capital formation*

Under the proposed rule, boards may assign fair value determinations to an investment adviser and oversee the investment adviser’s fair value determinations instead of determining fair value themselves, which could free board resources tied to valuation and redirect them to oversight or other matters. As a result, the proposed rule could lead to more efficient use of boards’ resources and therefore improve funds’ governance for the benefit of fund investors. The proposed rule also could improve the efficiency of fund operations because it would allow boards more flexibility to oversee the investment advisers’ fair value determinations instead of determining fair values themselves.

²⁴⁹ See *supra* Section III.C.1. for a discussion related to investment advisers’ conflicts of interest.

As discussed above, the proposed rule would mandate specific fair value policies and procedures and effective oversight of an assigned investment adviser, which could ultimately improve the efficiency of funds' asset prices. The proposed rule could improve the efficiency of asset prices because it could create a more robust valuation framework and it could help mitigate any conflicts of interest of the investment adviser, which ultimately could result in more accurate and unbiased asset prices. A potential increase in asset price efficiency could improve boards' monitoring of funds' and investment advisers' performance and could benefit capital formation because more accurate and unbiased prices permit the allocation of resources to their most efficient use. Nevertheless, we believe that any such effects likely would be small because many funds currently have in place fair value practices that are generally similar to the proposed rule's requirements and boards oversee the investment adviser's assistance with fair value calculations.

We do not believe that the proposed rule would have any material effects on competition because the effects of the rule likely would be small in light of the proposed rule's similarities to current practices. In particular, as discussed in Section III.C.3. above, the main costs arising from the proposed rule are the one-time costs to comply with the rule. Even though these costs could be more burdensome for smaller fund complexes, we believe that these costs would not affect competition in the fund industry, especially when considering that these are one-time costs that can be amortized over a number of years and because we believe that only few funds would incur costs at the higher end of the cost range estimate (*i.e.*, between \$100,000 and \$600,000). Consequently, we believe that the proposed rule would not affect competition in the fund industry.

In addition, the proposed rule's requirement to reasonably segregate the investment adviser's process of making fair value determinations from the portfolio management likely

would more significantly affect those smaller investment advisers that lack the staff and resources necessary to effect such segregation as efficiently as larger advisers and would otherwise need to hire additional personnel. Nevertheless, we do not believe that this requirement of the proposed rule would have a material effect on competition in the fund investment adviser industry because many smaller investment advisers to funds currently have in place processes to address the potential conflicts of interest whenever portfolio management personnel provides input to valuation.

D. Reasonable Alternatives

1. More principles-based approach

The proposed rule mandates the performance of certain prescribed functions to determine the fair value of fund investments in good faith. As an alternative to the proposed rule, we considered a more principles-based approach that would not specify the types of fair value functions that must be performed, but instead would only state that funds should have in place policies and procedures, reporting, and recordkeeping that would allow fair values to be determined in good faith by the board of directors or the investment adviser. The benefits of such an approach would be that funds would have more flexibility to tailor their policies and procedures, reporting, and recordkeeping to their valuation needs. Nevertheless, under such an approach funds could be less certain on how to comply with the proposed rule. To the extent this alternative would reduce certainty for funds, it could increase compliance costs to the detriment of fund investors, and it would not adequately ensure that the board provides sufficient oversight

over the investment adviser's fair value determinations.²⁵⁰ In addition, if certain funds within a fund complex would use the additional flexibility afforded by a more principles-based approach to set up policies and procedures, reporting, and recordkeeping arrangements that are different from one another, such flexibility could increase the cost of board oversight. This could occur because a board that is shared across funds within a fund complex would not be able to apply a similar framework across the various funds it oversees. Further, a more principles-based approach would not mandate a minimum prescribed set of fair value policies and procedures, reporting, and recordkeeping, unlike the proposed rule that would provide a consistent framework for funds to apply. Consequently, not all funds necessarily would put in place adequate policies and procedures, reporting, and recordkeeping to achieve accurate and unbiased fair value determinations.

2. *Assignment of responsibilities to service providers other than investment advisers*

Under the proposed rule, the board may assign the fair value determinations to an investment adviser to the fund, which would carry out all of the functions required under the rule. As an alternative, we considered allowing the board to assign the fair value determinations to service providers other than the investment adviser, such as a pricing service provider. Such an approach would provide additional flexibility to the board to assign the fair value determinations to appropriate persons. As a result, this alternative could free up board resources tied to the determination of fair value and redirect them to oversight, in situations where an

²⁵⁰ We acknowledge that under the proposed rule, funds could face some uncertainty regarding how to comply with the proposed rule's requirements. Nevertheless, we believe that a more principles-based approach than the proposed rule would increase further any uncertainty regarding how to comply with the proposed rule's requirements.

adviser was unwilling or unable to accept the responsibility to determine the fair value of fund investments and another third party was available to accept the assignment. Nevertheless, such an approach potentially could limit a board's ability to effectively oversee the service provider that performs the fair value determinations 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. Further, 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. Hence, such an alternative approach could compromise the integrity of the fair values.

3. *Not permit boards to assign fair value determinations to an investment adviser*

As discussed in more detail above, unlike the current regulatory framework, the proposed rule would permit fund boards to assign the fair value determinations to an investment adviser. In addition, relative to the current regulatory framework, the proposed rule would mandate more specific fair value policies and procedures, reporting, and recordkeeping. As an alternative to the proposed rule, we considered not permitting fund boards to assign the fair value determinations to an investment adviser to the fund but instead only requiring funds to adopt the policies and procedures, reporting, and recordkeeping as described in the proposed rule. We also considered requiring boards periodically to ratify the fair value determinations calculated by the fund's adviser using the methodology determined by the board. Such an approach could prescribe minimum requirements with respect to valuation policies and procedures, reporting, and recordkeeping. Nevertheless, such an approach would not allow funds the flexibility to leverage

the fair value expertise of the investment adviser and assign a role to the fund's board that is more in line with the board's experience and expertise. Relatedly, we believe that such an approach would not result in more efficient use of boards' time and more efficient fund operations, and would not result in improvements in fund governance, which would ultimately benefit fund investors.

E. Request for Comment

We request comment on all aspects of our economic analysis, including the potential costs and benefits of the proposed rule and alternatives thereto, and whether the proposed rule, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data, estimation methodologies, and other factual support for their views, in particular, on costs and benefits estimates. In addition, we request comment on the following:

58. Is our understanding regarding boards' current fair value practices correct? If not, please describe boards' current fair value practices. In particular, how do boards determine the fair values of fund investments in good faith? What type of assistance do boards receive with respect to fair value determinations? Who assists the board with the fair value determinations? To what extent and under what circumstances does information from pricing services assist the board with fair value determinations? What kinds of services do pricing services provide? What percentage of fund boards receive assistance with the fair value determinations? Does this percentage differ with the type of fund or with the type of fund investments? What types of fair value practices and policies and procedures do funds have in place? What types of reports related to valuation do

fund boards currently receive and how frequently do they receive these reports?

What types of records related to valuation do funds retain? For how long do they retain these records? Do these practices differ with the type of fund or with the type of fund investments?

59. Is our assumption correct that the vast majority of current and prospective fund boards would assign fair value determinations to an investment adviser under the proposed rule? If not, what percentage of current and prospective funds would assign the fair value determinations to an investment adviser to the fund? Do these percentages vary with the type of fund or with the type of fund investments? What factors would boards consider when deciding whether to assign the fair value determinations to an investment adviser to the fund?
60. What percentage of fund independent board members have valuation experience and expertise? Please provide data on the percentage of fund independent board members that have valuation experience and expertise by fund type.
61. Are there any entities affected by the proposed rule that are not discussed in the economic analysis? In which ways would those entities be affected by the proposed rule? Please provide an estimate of the number and size of those affected entities and of the nature and magnitude of the effect. Is our assessment correct that the effects of the proposed rule on UITs would be similar to the effects of the proposed rule on other funds, except for the fact that UITs would not bear any costs associated with oversight and reporting and their trustees would not receive any of the benefits associated with assigning fair value determinations to an investment adviser? Is our understanding correct that the proposed rule

would not have significant effects on pricing services? If not, please describe any effects the proposed rule would have on pricing services.

62. Do UITs' exposures to investments that use Level 1, 2, and 3 inputs differ from the exposure of other registered investment companies? What percentage of UITs hold investments that use Level 1, 2, and 3 inputs respectively?
63. In which ways do funds' current practices differ from the policies and procedures, reporting, and recordkeeping and other activities mandated by the proposed rule? Is our understanding correct that current funds' practices are largely similar to the policies and procedures, reporting, and recordkeeping and other requirements of the proposed rule?
64. Are there any costs and benefits of the proposed rule that are not discussed in the economic analysis? If so, please describe the types of costs and benefits and provide a dollar estimate of these costs and benefits.
65. Please provide any estimates of the board time and other savings arising from the assignment of fair value determinations to an investment adviser to the fund under the proposed rule. What is the source of these savings? How would the board utilize any savings as the result of the assignment of the fair value determinations to an investment adviser to the fund under the proposed rule? Would the boards engage in additional activities at meetings or would the boards instead spend less time on fund matters? Please provide dollar estimates (mean, median, standard deviation, minimum, and maximum) of these savings? Would these savings differ by fund? If yes, in which way?

66. Please provide a list of activities that would give rise to one-time costs for funds under the proposed rule. Also please provide dollar estimates (mean, median, standard deviation, minimum, and maximum) of the one-time costs that funds would incur. Would these costs differ by fund? If yes, in which ways? What percentage of these costs would be borne by the board and what percentage by an investment adviser to the fund? What percentage of these costs would be passed on to fund investors in the form of higher operating expenses or higher management fees?
67. Is our understanding correct that the incremental ongoing operating costs for funds would be minimal under the proposed rule? If not, please provide an estimate of the number of funds that would bear ongoing costs under the proposed rule. Also, please describe the activities that would give rise to ongoing costs for funds under the proposed rule, and an estimate of the costs associated with each activity. Would these costs differ by fund? If yes, in which ways? Which of these costs would be borne by the board and which by the investment adviser to the fund? What percentage of these costs would be passed down to fund investors in the form of higher operating expenses or higher management fees?
68. Would the proposed rule increase the fees of investment advisers or trustees of UITs? If yes, why and how? Please provide an estimate of the increase in the investment advisers' or trustees' fees.
69. What would be the effects of the proposed rule, including any effects on efficiency, competition, and capital formation? Would the proposed rule be beneficial or detrimental to funds and their investors? Would the proposed rule

affect competition in the fund industry? If yes, why? Would the proposed rule affect the efficiency of the prices of fund investments? If so, in which way?

70. Would a more principles-based approach relative to the proposed rule be preferable? If yes, why? If we did adopt such an approach, what safeguards would be necessary to ensure that fair value determinations are not influenced by conflicts of interest?
71. Would it be preferable to allow the board to assign the fair value determinations to service providers other than the investment adviser, such as a pricing service provider? If yes, why?
72. Would it be preferable to not permit boards to assign fair value determinations to an investment adviser to the fund but only mandate fair value policies and procedures, reporting, and recordkeeping requirements that are similar to the proposed rule's requirements? If yes, why?

IV. PAPERWORK REDUCTION ACT ANALYSIS

A. Introduction

Proposed rule 2a-5 would result in new “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).²⁵¹ The title for the new collection of information would be “Rule 2a-5 under the Investment Company Act of 1940, Fair Value.” The Commission is submitting these collections of information to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR

²⁵¹ 44 U.S.C. 3501-3520.

1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently-valid control number.

The proposed rule would provide requirements for determining fair value in good faith for purposes of section 2(a)(41) and rule 2a-4 thereunder. This determination would involve assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; evaluating any pricing services used; adopting and implementing policies and procedures; and maintaining certain records. The proposed rule would permit a fund's board of directors to assign the fair value determination relating to any or all fund investments to an investment adviser of the fund, which would carry out all of these requirements, subject to board oversight and certain reporting, recordkeeping, and other requirements designed to facilitate the board's ability effectively to oversee the adviser's fair value determinations. As relevant here, the rule would require, on a per fund basis, the adoption and implementation of certain policies and procedures designed to address the process for determining fair value in good faith, keeping of certain records regarding the fair value process, and, if the board assigns the adviser to determine fair value, adviser reporting to the board in both periodic and as needed reports with some extra recordkeeping.²⁵²

The respondents to proposed rule 2a-5 would be registered investment companies and BDCs.²⁵³ We estimate that 9,986 funds would be affected by rule 2a-5, of which 9,501 are not UITs.²⁵⁴ Compliance with rule 2a-5 would be mandatory for any fund that would need to

²⁵² Proposed rule 2a-5(a) and (b).

²⁵³ See proposed rule 2a-5(e)(1) (defining "fund").

²⁵⁴ See *supra* footnote 215 and accompanying text.

determine fair value under the Act. To the extent that records would be required to be created and maintained under the rule are provided to the Commission in connection with examinations or investigations, such information would be kept confidential subject to the provisions of applicable law.

B. Policies and Procedures

Proposed rule 2a-5 would require the adoption and implementation of fair value policies and procedures, which would address the process for the determination of the fair value of the fund's investments under the proposed rule.²⁵⁵ The fair value policies and procedures are designed to help ensure that the determination of fair value is carried out effectively and to facilitate board oversight. The policies and procedures, as proposed, must be reasonably designed to achieve compliance with the certain requirements of the proposed rule, which are: (1) periodically assessing any material risks associated with the determination of the fair value, including material conflicts of interest, and managing those identified valuation risks; (2) selecting and applying in a consistent manner methodologies for determining and calculating the fair value; (3) testing the appropriateness and accuracy of the fair value methodologies that have been selected; and (4) selecting and overseeing pricing service providers, if used.

We believe that the fund's board or adviser likely would establish the fair value policies and procedures by adjusting the current systems for implementing and enforcing the compliance

The Commission's estimates of the relevant wage rates in the tables below are based on salary information for the securities industry compiled by the Securities Industry and Financial Markets Association's Office Salaries in the Securities Industry 2013. The estimated wage figures are modified by Commission staff to account for an 1,800-hour work-year and inflation, and multiplied by 5.35 to account for bonuses, firm size, employee benefits, overhead, and adjusted to account for the effects of inflation. *See* Securities Industry and Financial Markets Association, Report on Management & Professional Earnings in the Securities Industry 2013 ("SIFMA Report").

²⁵⁵

See supra Section II.E.2.

policies and procedures of the fund (if the requirements are not assigned) or the adviser's (if the requirements are assigned). While funds and advisers have policies and procedures in place to address compliance with the federal securities laws (among other obligations), including fair value determinations, they would need to update their existing policies and procedures to account for the specific requirements of proposed rule 2a-5. To comply with this obligation, we believe that fund boards or advisers (by assignment by the board) would use in-house legal and compliance counsel to update existing policies and procedures to account for the requirements of proposed rule 2a-5. For purposes of these PRA estimates, we assume that either the fund or the adviser would review the fair value policies and procedures annually (for example, to assess whether the fair value methodology requires adjustments). We therefore have estimated initial and ongoing burdens associated with the proposed policies and procedures requirement. As discussed above, we estimate that approximately 9,986 funds may rely on the proposed rule and therefore would require these funds or their advisers to adopt and implement fair value policies and procedures.

Table 1 below summarizes the proposed PRA initial and ongoing burden estimates associated with the policies and procedures requirements under proposed rule 2a-5.

Table 1: Fair Value Policies and Procedures PRA Estimates

	Internal initial burden hours	Internal annual burden hours ¹		Wage rate ²	Internal time costs	Initial external cost burden	Annual external cost burden
Establishing and implementing rule 2a-5 policies and procedures	6 hours	2 hours	x	\$329 (senior manager)	\$658.00	\$3,000.00	\$1,000.00
	6 hours	2 hours	x	\$466 (ass't general counsel)	\$932.00		
	3 hours	1 hour	x	\$530 (chief compliance officer)	\$530.00		
	3 hours	1 hour	x	\$365 (compliance attorney)	\$365.00		
Reviewing and updating rule 2a-5 policies and procedures		3 hours	x	\$329 (senior manager)	\$987.00		\$1,000.00
		3 hour	x	\$466 (ass't general counsel)	\$1,398.00		
		1 hour	x	\$530 (chief compliance officer)	\$530.00		
Total annual burden per fund		13 hours			\$5,400.00		\$2,000.00
Number of affected funds		9,986			9,986		9,986
Total annual burden		129,818 hours			\$53,924,400		\$19,972,000

Notes:

1. Includes initial burden estimates annualized over a three-year period.
2. See SIFMA Report, *supra* footnote 254.

C. Board Reporting

The proposed rule would require, if the board assigns the fair value determinations to an adviser of the fund, that the adviser report to the fund's board in writing (1) a quarterly report containing an assessment of the adequacy and effectiveness of the adviser's process for determining the fair value of the assigned portfolio of investments and (2) promptly (but in no event later than three business days after the adviser becomes aware of the matter) 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. These reports would be required to include such information as may be reasonably necessary for the board to evaluate the matters covered in the report.²⁵⁶ The periodic reports that would be required by the proposed rule would have a minimum of five items required as part of the report,²⁵⁷ and the prompt reports must include material weaknesses in the design or implementation of the adviser's fair value determination process or material changes in the fund's risks as would be required elsewhere under the proposal.²⁵⁸ UITs could not assign fair value determinations to an adviser under the proposed rule because they are unmanaged and therefore would not be subject to this collection of information.²⁵⁹ We estimate that 9,501 funds would utilize the proposed rule and therefore be subject to these requirements.²⁶⁰

²⁵⁶ See proposed rule 2a-5(b)(1); *supra* section II.B.2 (discussing the proposed board reporting requirements).

²⁵⁷ See proposed rule 2a-5(b)(1)(i).

²⁵⁸ See proposed rule 2a-5(b)(1)(ii).

²⁵⁹ See proposed rule 2a-5(d).

²⁶⁰ See *supra* footnote 215.

Table 2 below summarizes the proposed PRA initial and ongoing burden estimates associated with the board reporting requirements under proposed rule 2a-5.

Table 2: Board Reporting PRA Estimates

	Internal initial burden hours	Internal annual burden hours		Wage rate ¹	Internal time costs	Initial external cost burden	Annual external cost burden
PROPOSED ESTIMATES							
	0 hours	8 hours	×	\$329 (senior manager)	\$2,632	\$2,000	\$2,000
Adviser written reports ²	0 hours	1 hour	×	\$17,860 (combined rate for 4 directors)	\$17,860		
	0 hours	1 hour	×	\$365 (compliance attorney)	\$365		
Total annual burden per fund		10 hours			\$20,857		\$2,000
Number of funds		× 9,501			× 9,501		× 9,501
Total annual burden		95,010 hours			\$198,162,357		\$19,002,000
Notes:							
1. See SIFMA Report, <i>supra</i> footnote 254.							
2. See <i>supra</i> footnotes 245-247 and accompanying text.							

D. Recordkeeping

Proposed rule 2a-5 would require the maintenance of certain records, specifically (1) 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 and (2) copies of the policies and procedures as required elsewhere under the proposed rule.²⁶¹ Further, if the board assigns fair value determinations to an adviser, the fund must maintain copies of (3) the reports and other information provided to the board as required elsewhere under the proposed rule and (4) a specified list of the investments or investment types whose fair value determination has been assigned to the adviser.²⁶² We estimate that 9,986 funds would be subject to the proposed rule and therefore to these requirements.²⁶³

Table 3 below summarizes the proposed PRA initial and ongoing burden estimates associated with the recordkeeping requirements under proposed rule 2a-5.

²⁶¹ See proposed rule 2a-5(a)(6); *supra* section II.A.6.

²⁶² See proposed rule 2a-5(b)(3); *supra* section II.B.6.

²⁶³ While only 9,501 of these 9,986 funds would be subject to the last two of these recordkeeping requirements, we believe that this distinction is immaterial for this purpose and would result in only a de minimis lowering of the estimate. See also *supra* footnote 215 and accompanying text.

Table 3: Recordkeeping PRA Estimates

	Internal initial burden hours	Internal annual burden hours ¹	Wage rate ²	Internal time costs	Initial external cost burden	Annual external cost burden
PROPOSED ESTIMATES						
Establishing recordkeeping policies and procedures	1.5	.5	\$62 (general clerk)	\$31	\$1,800	\$1,800
	1.5	.5	\$95 (senior computer operator)	\$47.50		
Recordkeeping	0 hours	2 hours	×	\$62 (general clerk)	\$0	\$0
	0 hours	2 hours	×	\$95 (senior computer operator)		
Total annual burden per fund		5 hours		\$157		\$600
Number of funds		× 9,986		× 9,986		× 9,986
Total annual burden		49,930 hours		\$1,567,802		\$5,991,600

Notes:

1. For "Establishing Recordkeeping Policies and Procedures," these estimates include initial burden estimates annualized over a three-year period.
2. See SIFMA Report, *supra* footnote 254.

E. Proposed Rule 2a-5 Total Estimated Burden

As summarized in Table 4 below, we estimate that the total hour burdens and time costs associated with proposed rule 2a-5, including the burden associated with the adoption and implementation of fair value policies and procedures, board reporting, and recordkeeping requirements, amortized over three years, would result in an average aggregate annual burden of 274,758 hours and an average aggregate annual monetized time cost of \$253,654,559. We also estimate that, amortized over three years, there would be external costs of \$44,965,600 associated with this collection of information. Therefore, each fund required to comply with the rule would incur an average annual burden of approximately 27.51 hours, at an average annual monetized time cost of approximately \$25,401, and an external cost of \$4,503 to comply with proposed rule 2a-5.

Table 4: Proposed Rule 2a-5 Total PRA Estimates

	Internal hour burden	Internal burden time cost	External cost burden
Policies and Procedures	129,818 hours	\$53,924,400	\$19,972,000
Board reporting	95,010 hours	\$198,162,357	\$19,002,000
Recordkeeping requirements	49,930 hours	\$1,567,802	\$5,991,600
Total annual burden	274,758	\$253,654,559	\$44,965,600
Number of funds	÷ 9,986	÷ 9,986	÷ 9,986
Average annual burden per fund	27.51 hours	\$25,401	\$4,503

F. Request for Comment

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (1) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (2) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information;

(3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed rules and amendments should direct them to the OMB:

MBX.OMB.OIRA.SEC_desk_officer@omb.eop.gov, and should send a copy of their comments to, Vanessa Countryman, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-07-20. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-07-20, and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street, NE, Washington, DC 20549- 2736.

V. INITIAL REGULATORY FLEXIBILITY ANALYSIS

The Commission has prepared the following Initial Regulatory Flexibility Analysis (“IRFA”) in accordance with section 3(a) of the Regulatory Flexibility Act (“RFA”).²⁶⁴ It relates to proposed rule 2a-5.

A. Reasons for and Objectives of the Proposed Actions

²⁶⁴ 5 U.S.C. 603(a).

The Commission is proposing new rule 2a-5 in order to address practices and the role of the board of directors with respect to the fair value of the investments of fund. Under section 2(a)(41), the board must determine in good faith the fair value of fund assets for which no market quotations are readily available. The proposed rule is designed to specify how a board or adviser must make good faith determinations of fair value as well as when the board can assign this function to an adviser to the fund, while still ensuring that fund investments are valued in a way consistent with the Investment Company Act.

The proposed rule would provide requirements for determining fair value in good faith for purposes of section 2(a)(41) of the Act and rule 2a-4 thereunder. This determination would involve assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; evaluating any pricing services used; adopting and implementing policies and procedures; and maintaining certain records. The proposed rule would permit a fund's board of directors to assign these requirements to an investment adviser to the fund for some or all of the fund's investments, subject to board oversight and certain reporting, recordkeeping, and other requirements designed to facilitate the board's ability effectively to oversee the adviser's fair value determinations. The proposed rule would also define when market quotations are readily available under section 2(a)(41) of the Act. Lastly, the proposed rule would have the trustee of a UIT carry out the requirements of the proposed rule. The requirements associated with the fair value as determined in good faith and readily available market quotations are designed to protect investors from improper valuations and reflect our view of current market best practices.²⁶⁵ The requirements associated with the

²⁶⁵ See *supra* sections I, II.A, and II.C.

assignment of responsibilities to an adviser are designed to ensure that the board effectively oversees an assigned adviser, including receiving sufficient information to do so.²⁶⁶ The policies and procedures and recordkeeping requirements are designed to help ensure compliance with the other requirements.²⁶⁷

All of these requirements are discussed in detail in section II of this release. The costs and burdens of these requirements on small funds and investment advisers are discussed below as well as above in our Economic Analysis and Paperwork Reduction Act Analysis, which discuss the applicable costs and burdens on all funds and investment advisers.²⁶⁸

B. Legal Basis

The Commission is proposing new rule 2a-5 under the authority set forth in sections 2(a), 6(c), 31(a), 31(c), and 38(a) of the Investment Company Act of 1940 [15 U.S.C. 80a-2(a), 80a-6(c), 80a-30(a), 80a-30(c), and 80a-37(a)].

C. Small Entities Subject to Proposed Rules

For purposes of Commission rulemaking in connection with the Regulatory Flexibility Act, an investment company is a small entity if, together with other investment companies in the same group of related investment companies, it has net assets of \$50 million or less as of the end of its most recent fiscal year (a “small fund”).²⁶⁹ Commission staff estimates that, as of

²⁶⁶ See *supra* section II.B.

²⁶⁷ See *supra* sections II.A.6 and II.B.4.

²⁶⁸ See *supra* section III and IV. These sections also discuss the professional skills that we believe compliance with the proposed rule would entail.

²⁶⁹ See rule 0-10(a) under the Investment Company Act [17 CFR 270.0-10(a)].

December 2019, approximately 38 registered open-end mutual funds, 8 registered ETFs, 30 registered closed-end funds, 2 UITs, and 14 BDCs (collectively, 92 funds) are small entities.²⁷⁰

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

Proposed rule 2a-5 would require fair value determinations under the Act be made according to a specific process for affected funds, including those that are small entities. This process would include the adoption of policies and procedures reasonably designed to achieve compliance with the requirements of the proposed rule and certain recordkeeping requirements. Further, the proposed rule would permit certain fund boards to assign fair value determinations to an adviser to the fund if the adviser, in addition to the above, adopts certain policies and procedures, makes certain reports to the fund's board regarding the fair value process in writing. Funds would also be required to keep certain additional records in such circumstances. We therefore believe that there are three principal reporting, recordkeeping, or other compliance requirements associated with the proposed rule: (1) the establishment and implementation of policies and procedures, including establishing and applying fair value methodologies, (2) recordkeeping requirements, and (3) board reporting requirements.

1. Policies and Procedures

The policies and procedures that would be required under the proposed rule would need to be reasonably designed to achieve compliance with the requirements of the rule. Specifically, these requirements include (1) the assessment and management of risks associated with the determination of fair value, (2) establishing and applying fair value methodologies, (3) testing

²⁷⁰

This estimate is derived an analysis of data obtained from Morningstar Direct as well as data reported to the Commission for the period ending December 2019.

fair value methodologies, and (4) evaluating pricing services.²⁷¹ Further, if the board assigns fair value determinations under the proposed rule to an investment adviser to the fund, the adviser's policies and procedures must meet certain requirements. In addition to the other requirements above, these policies and procedures must specify the titles of the persons responsible for determining the fair value of assigned investments, including by specifying the particular functions for which they are responsible, and reasonably segregating the process of making fair value determinations from the portfolio management of the fund.²⁷²

These requirements are designed to implement the proposed rule's requirements effectively which, in turn, are designed to protect investors from improper valuations. They are also designed to facilitate the board's oversight of these functions when they are assigned to an adviser to the fund. These requirements will impose burdens on all funds, including those that are small entities. The specifics of these burdens are discussed in the Economic Analysis and Paperwork Reduction Act sections above.²⁷³

There are different factors that would affect whether a smaller fund incurs costs related to this requirement that are on the higher or lower end of the estimated range. For example, we would expect that smaller funds – and more specifically, smaller funds that are not part of a fund complex – may not have existing policies and procedures that include all of the elements that would be required of policies and procedures under the proposed rule. Also, while we would expect larger funds or funds that are part of a large fund complex to incur higher costs related to

²⁷¹ Proposed rule 2a-5(a)(1)-(5).

²⁷² See proposed rule 2a-5(b)(2).

²⁷³ See *supra* section III.C.3. This section, along with section IV, also discusses the professional skills that we believe compliance with this aspect of the proposal would entail.

this requirement in absolute terms relative to a smaller fund or a fund that is part of a smaller fund complex, we would expect a smaller fund to find it more costly, per dollar managed, to comply with the proposed requirement because it would not be able to benefit from a larger fund complex's economies of scale.²⁷⁴

2. *Recordkeeping*

The recordkeeping requirements of the proposed rule are designed to help ensure compliance with the rule's requirements and aid in oversight. The proposed rule would require the fund to keep the following records: (1) 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 for at least five years from the time the determination was made, the first two years in an easily accessible place and (2) A copy of the fair value policies and procedures that are in effect, or were in effect at any time within the past five years, in an easily accessible place.²⁷⁵ Further, should the board assign the fair value determination, the fund must keep, in addition to the records above, copies of the reports and other information provided to the board for at least five years after the end of the fiscal year in which the documents were made, the first two years in an easily accessible place and a specified list of the investments or investment types whose fair value determination has been assigned to the adviser, in each case for at least five years after the end of the fiscal year in

²⁷⁴ See *supra* section III.C.1.

²⁷⁵ Proposed rule 2a-5(a)(6).

which the determinations were provided to the board or the investments or investment types were assigned to the adviser, the first two years in an accessible place.²⁷⁶

These requirements will impose burdens on all funds, including those that are small entities. The specifics of these burdens are discussed in the Economic Analysis and Paperwork Reduction Act sections above.²⁷⁷ There are different factors that would affect whether a smaller fund incurs costs relating to this requirement that are on the higher or lower end of the estimated range. For example, we would expect that smaller funds – and more specifically, smaller funds that are not part of a fund complex – may not have recordkeeping systems that would meet all the elements that would be required under the proposed rule. Also, while we would expect larger funds or funds that are part of a large fund complex to incur higher costs related to this requirement in absolute terms relative to a smaller fund or a fund that is part of a smaller fund complex, we would expect a smaller fund to find it more costly, per dollar managed, to comply with the proposed requirement because it would not be able to benefit from a larger fund complex’s economies of scale.²⁷⁸

3. *Board Reporting*

The requirement for board reporting by the fund’s adviser is designed to ensure that the board can exercise sufficient oversight over the fair value process. The proposal would require two general types of reports, a periodic one and a prompt one. Periodic reports would consist of the adviser’s quarterly assessment in writing of the adequacy and effectiveness of the adviser’s

²⁷⁶ Proposed rule 2a-5(b)(3).

²⁷⁷ See *supra* section III.C.3. This section and section IV also discuss the professional skills that we believe compliance with this aspect of the proposal would entail.

²⁷⁸ See *supra* section III.C.1.

fair value process for determining the fair value of the assigned portfolio of investments, including some specific summaries and descriptions. The prompt reporting requirement would require advisers to promptly inform the board, but in no event later than three business days after the adviser becomes aware of the matter, of matters that materially affect or could materially affect 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 valuation risks.²⁷⁹

These requirements will impose burdens on all funds, including those that are small entities. The specifics of these burdens are discussed in the Economic Analysis and Paperwork Reduction Act sections above.²⁸⁰ There are different factors that would affect whether a smaller fund incurs costs related to this requirement that are on the higher or lower end of the estimated range. For example, we would expect that smaller funds – and more specifically, smaller funds that are not part of a fund complex – may not have an advisory agreement that has a reporting mechanism that would meet all the elements that would be required under the proposed rule. Also, while we would expect larger funds or funds that are part of a large fund complex to incur higher costs, via increased advisory fees for advisers to take on this responsibility on behalf of such funds, related to this requirement in absolute terms relative to a smaller fund or a fund that is part of a smaller fund complex, we would expect a smaller fund to find it more costly, per

²⁷⁹ See *supra* section II.B.2 and II.B.3.

²⁸⁰ See *supra* section III.C.3.

dollar managed, to comply with the proposed requirement because it would not be able to benefit from a larger fund complex's economies of scale.²⁸¹

E. Duplicative, Overlapping, or Conflicting Federal Rules

Other than as discussed below, Commission staff has not identified any federal rules that duplicate, overlap, or conflict with proposed rule 2a-5. As discussed in more detail above,²⁸² rule 38a-1 also would apply to a fund's obligations under the proposed rule. Rule 38a-1 requires a fund's board, including a majority of its independent directors, to approve the fund's policies and procedures, including those on fair value, and those of each investment adviser and other specified service providers, based upon a finding by the board that the policies and procedures are reasonably designed to prevent violation of the federal securities laws.²⁸³ Rule 38a-1 also requires that the fund's CCO provide an annual report to the fund's board that must address any material changes to compliance policies and procedures.²⁸⁴

Ultimately, we do not believe that the proposed rule adds cumulative regulatory burdens on small funds without any gain in regulatory benefits. The proposed rule would differ from the requirements of rule 38a-1 in that proposed rule 2a-5 would mandate that funds, including small funds, adhere to more specific fair value practices as well as policies and procedures, reporting, and recordkeeping requirements not currently required in the text of rule 38a-1. As we state above, however, to the extent that adviser policies and procedures under proposed rule 2a-5

²⁸¹ See *supra* section III.C.1.

²⁸² See *supra* section II.A.5.

²⁸³ Rule 38a-1(a)(2).

²⁸⁴ See rule 38a-1(a)(4)(iii)(A). "Material" in this context is a change that a fund director would reasonably need to know in order to oversee fund compliance. See rule 38a-1(e)(2). We have also said that "serious compliance issues" must be raised with the board immediately. See Compliance Rules Adopting Release, *supra* footnote 26, at n.33.

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 to avoid any duplication.²⁸⁵

F. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish our stated objective, while minimizing any significant economic impact on small entities. We considered the following alternatives for small entities in relation to our proposal: (1) exempting funds that are small entities from the proposed reporting, recordkeeping, and other compliance requirements, to account for resources available to small entities; (2) establishing different reporting, recordkeeping, and other compliance requirements or frequency, to account for resources available to small entities; (3) clarifying, consolidating, or simplifying the compliance requirements under the proposal for small entities; and (4) using performance rather than design standards.

We do not believe that exempting small funds from the provisions in proposed rule 2a-5 would permit us to achieve our stated objectives, principally to protect investors from improper valuations. Further, the board reporting and additional recordkeeping provisions of proposed rule 2a-5 only affect fund boards that assign fair value determinations to a fund adviser and, therefore, the rule would require funds to comply with these specific requirements only if they assigned responsibilities to their adviser. However, we expect that most funds holding securities that must be fair valued will do so. Therefore if a board to a small entity does not do this and instead performs its statutory function directly, then the small entity would not be subject to

²⁸⁵

See supra section II.A.5.

these provisions of proposed rule 2a-5.

We estimate that 72% of all funds would be subject to the proposed rule in making fair value determinations.²⁸⁶ This estimate indicates that some funds, including some small funds, would be unaffected by the proposed rule. However, for small funds that would be affected by our proposed rule, providing an exemption for them could subject investors in small funds to a higher degree of risk than investors to large funds that would be required to comply with the proposed elements of the rule.

As discussed throughout this release, we believe that the proposed rule would result in investor protection benefits, and these benefits should apply to investors in smaller funds as well as investors in larger funds. We therefore do not believe it would be appropriate to exempt small funds from the proposed rule's requirements, or to establish different requirements applicable to funds of different sizes under these provisions to account for resources available to small entities. We believe that all of the proposed elements of rule 2a-5 should work together to produce the anticipated investor protection benefits, and therefore do not believe it is appropriate to except smaller funds because we believe this would limit the benefits to investors in such funds.

We also do not believe that it would be appropriate to subject small funds to different reporting, recordkeeping, and other compliance requirements or frequency. Similar to the concerns discussed above, if the proposal included different requirements for small funds, it could raise investor protection concerns for investors in small funds in that small funds face the same conflicts of interest that can lead to mispricing and otherwise harm investors that larger funds do.

²⁸⁶ See *supra* footnote 214 and accompanying text.

We do not believe that clarifying, consolidating, or simplifying the compliance requirements under the proposal for small funds, beyond that already proposed for all funds, would permit us to achieve our stated objectives. Again, this approach would raise investor protection concerns for investors in small funds. We believe, as outlined above in the discussion of the proposed rule and the guidance contained in this release, that the requirements of the proposed rule are, to some extent, current industry practice under existing rules, with some changes from current practice. As a result, we think that the proposed rule could result in a reduction in the current burdens experienced by small entities to the extent that they are subject to the proposed rule.

The costs associated with proposed rule 2a-5 would vary depending on the fund's particular circumstances, and thus the proposed rule could result in different burdens on funds' resources. In particular, we expect that a fund that does not have policies and procedures, reporting, or recordkeeping practices similar to those proposed in the rule would need to modify those practices. Thus, to the extent a fund that is a small entity already has a fair value process that is consistent with the requirements of the proposed rule, we believe it would incur relatively low costs to comply with it. However, we believe that it is appropriate to correlate the costs associated with the proposed rule with the fund's actual fair value process, and not necessarily with the fund's size in light of our investor protection objectives.

Finally, with respect to the use of performance rather than design standards, the proposed rule generally uses performance standards for all funds subject to the proposed rule, regardless of size. We believe that providing funds with the flexibility permitted in the proposal with respect to designing specific fair value process is appropriate because of the fact-specific nature of making fair value determinations.

G. Request for Comment

73. The Commission requests comment regarding this analysis. We request comment on the number of small entities that would be subject to our proposal and whether our proposal would have any effects that have not been discussed. We request that commenters describe the nature of any effects on small entities subject to our proposal and provide empirical data to support the nature and extent of such effects. We also request comment on the estimated compliance burdens of our proposal and how they would affect small entities.

VI. CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (“SBREFA”), the Commission must advise OMB whether a proposed regulation constitutes a “major” rule. Under SBREFA, a rule is considered “major” where, if adopted, it results in or is likely to result in:

- An annual effect on the economy of \$100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.

We request comment on whether our proposal would be a “major rule” for purposes of SBREFA. We solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment, or innovation.

Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VII. STATUTORY AUTHORITY

The Commission is proposing new rule 2a-5 under the authority set forth in sections 2(a), 6(c), 31(a), 31(c), and 38(a) of the Investment Company Act of 1940 [15 U.S.C. 80a-2(a), 80a-6(c), 80a-30(a), 80a-31(c), and 80a-37(a)].

List of Subjects

17 CFR Part 210

Accountants, Accounting, Banks, banking, Employee benefit plans, Holding companies, Insurance companies, Investment companies, Oil and gas exploration, Reporting and recordkeeping requirements, Securities, Utilities.

17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulation is proposed to be amended as follows:

PART 210 – FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for part 210 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77nn(25), 77nn(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, and sec. 102(c), Pub. L. 112-106, 126 Stat. 310 (2012), unless otherwise noted.

* * * * *

2. Section 210.6-03 is amended by revising paragraph (d) to read as follows:

§210.6-03 Special rules of general application to registered investment companies and business development companies.

* * * * *

(d) *Valuation of investments.* The balance sheets of registered investment companies, other than issuers of face-amount certificates, and business development companies, shall reflect

all investments at value, with the aggregate cost of each category of investment reported under §§210.6-04.1, 6-04.2, 6-04.3, and 6-04.9 or the aggregate cost of each category of investment reported under §210.6-05.1 shown parenthetically. State in a note the methods used in determining the value of investments. As required by section 28(b) of the Investment Company Act of 1940 (15 U.S.C. 80a-28(b)), qualified assets of face-amount certificate companies shall be valued in accordance with certain provisions of the Code of the District of Columbia.

* * * * *

PART 270 – RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

3. The authority citation for part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, 80a-39, and Pub. L. 111-203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

4. Section 270.2a-5 is added to read as follows:

§ 270.2a-5 Fair value determination and readily available market quotations.

(a) *Fair value determination.* For purposes of section 2(a)(41) of the Act (15 U.S.C. 80a-2(a)(41)) and § 270.2a-4, determining fair value in good faith with respect to a fund requires:

(1) *Assess and manage risks.* Periodically assessing any material risks associated with the determination of the fair value of fund investments (“valuation risks”), including material conflicts of interest, and managing those identified valuation risks;

(2) *Establish and apply fair value methodologies.* Performing each of the following, taking into account the fund’s valuation risks:

(i) Selecting and applying in a consistent manner an appropriate methodology or methodologies for determining (and calculating) the fair value of fund investments, including specifying:

(A) The key inputs and assumptions specific to each asset class or portfolio holding; and

(B) Which methodologies apply to new types of fund investments in which a fund intends to invest;

(ii) Periodically reviewing the appropriateness and accuracy of the methodologies selected and making any necessary adjustments thereto;

(iii) Monitoring for circumstances that may necessitate the use of fair value; and

(iv) Establishing criteria for determining when market quotations are no longer reliable;

(3) *Test fair value methodologies.* Testing the appropriateness and accuracy of the fair value methodologies that have been selected, including identifying the testing methods to be used and the minimum frequency with which such testing methods are used;

(4) *Evaluate pricing services.* Overseeing pricing service providers, if used, including establishing:

(i) The process for the approval, monitoring, and evaluation of each pricing service provider, and

(ii) Criteria for initiating price challenges;

(5) *Fair value policies and procedures.* Adopting and implementing written policies and procedures addressing the determination of the fair value of fund investments that are reasonably designed to achieve compliance with the requirements described in paragraphs (a)(1) through (4) of this section; and

(6) *Recordkeeping*. Maintaining:

(i) 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, for at least five years from the time the determination was made, the first two years in an easily accessible place; and

(ii) A copy of policies and procedures as required under paragraph (a)(5) of this section that are in effect, or were in effect at any time within the past five years, in an easily accessible place.

(b) *Performance of fair value determinations*. The board of the fund must determine fair value in good faith for any or all fund investments by carrying out the functions required in paragraph (a) of this section. The board may choose to assign the fair value determination relating to any or all fund investments to an investment adviser of the fund, which would carry out all of the functions required in paragraphs (a)(1) through (5) of this section, subject to the requirements of this paragraph (b). If the board of the fund does not assign fair value determinations to an adviser to the fund, the fund must adopt and implement the policies and procedures required under paragraph (a)(5) of this section and maintain the records required by paragraph (a)(6) of this section.

(1) *Oversight and reporting*. The board oversees the adviser, and the adviser reports to the fund's board, in writing, including such information as may be reasonably necessary for the board to evaluate the matters covered in the report, as follows:

(i) *Periodic reporting.* At least quarterly, an assessment of the adequacy and effectiveness of the investment adviser's process for determining the fair value of the assigned portfolio of investments, including, at a minimum, a summary or description of:

(A) The assessment and management of material valuation risks required under paragraph (a)(1) of this section, including any material conflicts of interest of the investment adviser (and any other service provider);

(B) Any material changes to, or material deviations from, the fair value methodologies established under paragraph (a)(2) of this section;

(C) The results of the testing of fair value methodologies required under paragraph (a)(3) of this section;

(D) 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 under paragraph (b)(2) of this section;

(E) 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 (such as changes in the service providers used or price overrides); and

(F) Any other materials requested by the board related to the adviser's process for determining the fair value of assigned investments; and

(ii) *Prompt board reporting.* The adviser reports promptly (but in no event later than three business days after the adviser becomes aware of the matter) 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 under paragraph (a)(1) of this section;

(2) *Specify responsibilities.* The adviser specifies the titles of the persons responsible for determining the fair value of the assigned investments, including by specifying the particular functions for which they are responsible, and reasonably segregates the process of making fair value determinations from the portfolio management of the fund; and

(3) *Records when assigning.* In addition to the records required in paragraph (a)(6) of this section, the fund maintains copies of:

(i) The reports and other information provided to the board as required under paragraph (b)(1) of this section; and

(ii) A specified list of the investments or investment types whose fair value determination has been assigned to the adviser pursuant to this paragraph (b), in each case for at least five years after the end of the fiscal year in which the documents were provided to the board or the investments or investment types were assigned to the adviser, the first two years in an easily accessible place.

(c) *Readily available market quotations.* For purposes of section 2(a)(41) of the Act (15 U.S.C. 80a-2(a)(41)), a market quotation is readily available only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable.

(d) *Unit investment trusts.* If the fund is a unit investment trust, the fund's trustee must carry out the requirements of paragraph (a) of this section.

(e) *Definitions.* For purposes of this section:

(1) *Fund* means a registered investment company or business development company.

(2) *Fair value* means the value of a portfolio investment for which market quotations are not readily available under paragraph (c) of this section.

(3) *Board* means either the fund's entire board of directors or a designated committee of such board composed of a majority of directors who are not interested persons of the fund.

By the Commission.

Dated: April 21, 2020

Vanessa A. Countryman
Secretary

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