MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

July 21, 2020

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

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

Dear Ms. Countryman:

The Mutual Fund Directors Forum ("the Forum")[1] welcomes the opportunity to comment on the Commission's recent rule proposal regarding the good faith determination of fair value.[2]

The Forum is an independent, non-profit organization for investment company independent directors and is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through education and other services, the Forum provides its members with opportunities to share ideas, experiences and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern.

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I Introduction

The Forum strongly welcomes the Commission's proposal on good faith fair valuation. We are particularly pleased by the Commission's efforts to clearly and expressly authorize fund boards to assign the day-to-day process of fair valuing portfolio securities that lack readily available market quotations to the fund's adviser and its efforts to clarify the role that boards play

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1 The Forum's current membership includes over 887 independent directors, representing 122 mutual fund groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

2 *See* Good Faith Determinations of Fair Value, Release No. IC-33845 (File No. S7-07-20), 85 Fed. Reg. 28734 (May 13, 2020) (hereinafter "Proposing Release").

in providing oversight of the valuation process on behalf of their funds and those funds' shareholders.

At the same time, we are concerned that the Commission's detailed enumeration of requirements regarding the nature of the board's oversight, the elements of the oversight process and the frequency and content of the reports that advisers provide to boards about the fair valuation process unnecessarily intrude on the board's business judgment regarding how best to oversee the funds for which they are responsible and may, inadvertently, divert board time from other risks that might threaten shareholders. As we outline in more detail below, boards have significant expertise in structuring and engaging in the oversight process. Defining that process overly specifically by regulation is unlikely to improve the fair valuation of portfolio securities and risks reducing the effectiveness of board oversight.

In addition, we strongly encourage the Commission to characterize the rule as a safe harbor, and thus make clear that the rule is not the exclusive means by which boards can satisfy their fair valuation obligations under the Investment Company Act of 1940 ("the Act"). While we support the Commission's efforts to outline a process by which boards can definitively meet their statutory fair valuation obligations, we do not believe that the process outlined by the Commission is the only means by which boards can do so. As outlined below, we encourage the Commission to recognize this fact.

II. Comments

A. The Importance of the Commission's Proposal

We welcome the Commission's rule proposal on fair valuation. As described in the Proposing Release, the Commission's key releases on valuation are very old and do not reflect current market dynamics or the current practices of advisers and boards. Similarly, years of interpretations and other guidance provided by the Commission and staff can be difficult to piece together and are at times contradictory or otherwise confusing. The Commission's approach of proposing a single rule and revoking much of its prior guidance on and regulation of fair value is thus timely and highly welcome. We are also pleased that, for the most part, the proposed rule will provide a concise, coherent, consistent and authoritative statement of the Commission's regulatory expectations regarding fair valuation. This is an important step forward.

Equally important is the framework of the proposed rule. As the Proposing Release recognizes, boards, who tend to be informed, engaged generalists rather than valuation specialists and who meet periodically through the year rather than engaging more regularly in the activities of the funds they oversee, are not in a strong position to value securities that lack readily available market quotations on a daily basis. Fund advisers, in contrast, who typically have the primary responsibility for the ongoing operations of the funds they manage, are in a much better position to assemble the necessary expert personnel and outside service providers to fair value securities on a daily basis. The proposed rule's recognition that boards need to be able to assign[3] this task

[3] In the Proposing Release, the Commission chooses to use the term "assign" (instead of, for example, the term "delegate") to describe the board's activity in transferring the obligation to determine fair values to the adviser. The Proposing Release does not, however, specifically state what the Commission believes the term

to advisers in order for the fair valuation process to operate effectively and efficiently – and its clear authorization for them to do so – is of fundamental importance. We strongly support the Commission taking this step.

As part of this, we strongly support the Commission's decision to rescind prior Commission and staff statements regarding fair valuation. Doing so not only eliminates regulation that is out-of-date and not reflective of current market conditions and industry best practices but is also important to maintaining the coherence and effectiveness of the Commission's overall approach. Confining the Commission's views of fair valuation to a single rule will be of significant value to directors and the industry as a whole.

Finally, we also recognize the important role that board oversight plays with respect to fair valuation. As the Proposing Release describes in detail, valuing portfolio securities accurately is of fundamental importance to fund shareholders, as, among other things, it correlates to the price at which shareholders purchase and redeem fund shares, impacts the fee paid to the adviser, especially where performance fees are involved, and plays a role in a fund's compliance with its investment restrictions. Boards thus do not have just a statutory obligation with respect to fair valuation, but also a fiduciary interest in overseeing whether the fair valuation processes employed by the adviser appropriately protect the interests of fund shareholders. We thus agree with the Commission that effective board oversight of fair valuation should have a fundamental place in this rulemaking.

B. **The Structure of Board Oversight**

While we fully agree that a board that assigns fair valuation to its fund adviser should vigorously oversee the adviser's approach to fair valuation, we are concerned that the rule, as proposed, places too many specific requirements on how the board oversees the adviser's fair valuation program as well as the content and frequency of the adviser's reports to the boards.

As we have stressed in numerous comment letters and other papers, boards operate effectively when they oversee how a fund is managed and operated rather than try to operate or manage it themselves. In engaging in oversight, boards use their independence, access to information and business judgment to make appropriate determinations on behalf of the fund and its shareholders. Most fundamentally, therefore, we agree – at least in the vast majority of cases in which the board has assigned to the adviser the task of making fair value determinations – that it should be the board's obligation, pursuant to rule 38a-1, to oversee that the fund's policies and

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"assign" means. While we recognize that there has been considerable controversy in the past regarding whether a board can "delegate" its fair value obligations, including statements by the Commission that it cannot do so, and thus understand why the Commission might opt to use a different term, we are concerned that the Commission has chosen a term that is both rarely used in the context of investment company regulation and that can have a variety of meanings in business, commercial and contract law. We thus urge the Commission to clarify what it means by the use of the term "assign," and especially to explain, as appropriate, how its use of that term affects the respective legal obligations of the board as assignor and the adviser as assignee.

procedures regarding fair valuation are reasonably designed to ensure compliance with the rule and other requirements of the Act.[4]

Boards, however, exercise their business judgment not just with respect to making necessary determinations, but also in deciding how to structure their oversight of the funds for which they are responsible. In most circumstances, boards have broad discretion to determine what information to seek from the fund's adviser and other service providers, when and how to receive that information from the adviser, how to question the adviser about that information and how frequently to review the information.[5] Given the board's fundamental role in protecting shareholders, this makes sense, as every fund is different and presents unique circumstances, and hence boards are able to structure their approach to oversight over each individual fund to reflect the specific circumstances of that fund. By doing so, the set of investors who own each individual fund are protected in the most effective and efficient manner possible.

The proposed rule takes the opposite approach, particularly by requiring that boards receive information from the adviser about a broad range of topics relevant to the fair valuation program. Specifically, as proposed, the rule would require quarterly reporting by the adviser on material valuation risks, material changes to or deviations from the fair value methodologies used by the adviser, testing results, the adequacy of the resources devoted to the fair valuation process and material changes to the process for overseeing pricing services. Beyond that, the release lists other matters on which the board might opt to receive regular reporting.

While we agree that the factors and information identified by the Commission are likely to be relevant to many boards in a wide variety of circumstances, we nonetheless strongly believe that individual boards can and should be able to determine what information they find most relevant based on the individual circumstances of the funds they oversee and their duty to their shareholders. Boards must maintain their attention to the most fundamental risks to their shareholders. Frequent special escalations and voluminous reports create a not inconsequential risk of distraction from the most urgent issues. Such distraction can imperil the appropriate protection of shareholders – the first responsibility of boards. Structuring the requirement to allow boards to obtain the information they want without cluttering board books with materials that directors find unnecessary or unhelpful to their oversight would be the safest way to protect shareholder interests. Including unnecessary information in board materials can easily have the negative effect of distracting board attention from information that actually is of greater significance.

We are equally concerned with the Commission's delineation of information that "a board could review and consider, if relevant" such as summaries of adviser price challenges or specific

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4 *See* Proposing Release, *supra* note 2, at 28741.

5 There are obviously many circumstances in which the Act or the Commission's regulations require the board to make an annual determination – such as, for example, the annual renewal of the contract under section 15(c), but even under these requirements, the board generally has wide discretion to determine what information to seek from the adviser and how to structure the process of making the required determination.

calibration and back-testing data.[6] While the Commission attempts to characterize these reports as optional, boards often will have the adviser report this data not because they agree that it is relevant in the circumstances that they face, but because doing so avoids the risk of being second-guessed by regulators or others in the future.[7] As with the mandatory topics, this reporting risks filling board materials with information that the board finds unhelpful to its oversight process and distracting the board's attention from those materials that it finds enables and focuses its oversight activities. We believe a stronger approach would be for the Commission to clarify that a board seek to obtain all information that it believes relevant to its oversight responsibilities while simultaneously mandating that the adviser provide that information to the board, along with any other relevant information not requested by the board, but which the adviser might reasonably determine to be necessary to provide to the board.

We have the same concern with the proposed requirement that the board receive these materials from the adviser on a quarterly basis. Many if not all fund boards will conclude that quarterly reporting of at least the most important information regarding the fair valuation process is appropriate. Others, however, may find a different interval to be appropriate or may prefer to have some types of information reported more frequently or in greater detail than other types of information. Again, we believe that boards are well-situated to determine the frequency of reporting that will best enable them to engage in effective oversight given the facts and circumstances faced by the funds for which they are responsible.

Finally, we encourage the Commission to rethink the proposed mandate that the adviser report to the board within three business days issues that "materially affect, or could have materially affected, the fair value of the assigned portfolio of securities."[8] We agree with the Commission that there are circumstances in which an adviser should report to the board issues with the fair valuation process outside of the normal reporting cycle. However, there is no obvious rationale why three days is an appropriate time frame for this reporting. In many cases, that may not be long enough for the adviser to provide appropriate information to the board; in others, it may be too long. In addition, the Commission provides little insight into what sort of circumstance, event or data might "materially affect" the fair value of the "assigned portfolio of securities."[9] Recognizing the business judgment of the board we believe that a better approach would be to mandate that boards adopt policies and procedures in which they define escalation procedures

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6 *See* Proposing Release, *supra* note 2, at 28745. In total, the Commission lists at least nine types of additional information that boards might choose to consider.

7 We note, for example, that the "optional" factors that the Commission listed when it adopted rule 12b-1 as relevant to approving a 12b-1 plan are often treated as effectively mandatory by fund boards even when those factors have no relevance to the current distribution landscape. *See* Letter from David B. Smith Jr., General Counsel, Mutual Fund Directors Forum to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, Comments on Proposed Rulemaking Regarding Mutual Fund Distribution Fees at 7-8 (Nov. 5, 2010) (available at https://www.sec.gov/comments/s7-15-10/s71510-1073.pdf); *see also* Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Directors Under Rule 12b-1* at 12 (May 2007).

8 Proposing Release, *supra* note 2, at 28746.

9 *Id.*

appropriate for the individual fund that they oversee – that is, when, how and under what circumstances the adviser should report issues with the fair valuation process to the board.

In sum, we agree with the Commission 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."[10] The board's oversight function here is critically important, on a par with its role overseeing other important adviser functions like the oversight of liquidity risk and the oversight of risk resulting from a fund's use of derivatives. In recognizing the role of boards in these areas, the Commission is simultaneously placing enormous trust in the business judgment of the boards and in their ability to act in the interest of fund shareholders. Given that, the Commission should similarly place its trust in the ability and business judgment of boards to structure the oversight process for fair valuation by defining what materials they wish the adviser to provide, how those materials should be presented and with what frequency the adviser should report to the board.

C. **Oversight of Pricing Services**

Pricing services play an increasingly important role in the process of fair valuing securities for which there are not readily available market quotations. We thus believe that the Commission is correct to specifically identify the oversight of pricing services as a key element of the fair valuation policies and procedures of funds that employ them; as the Proposing Release recognizes, "the proposed rule would require that the board or adviser establish a process for the approval, monitoring, and evaluation of each pricing service provider."[11]

As we understand this approach, in situations in which the board has assigned fair valuation to the adviser, the adviser would perform this oversight of pricing services subject to the overall oversight of the board. In general, we agree that this dynamic is appropriate. However, this description seemingly conflicts with language the Commission has used in the past. In particular, in 2014, the Commission cautioned boards that use pricing services that they "may want to consider the inputs, methods, models, and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change."[12]

While this language is rooted in an explanation of the board's responsibilities under the to-be-rescinded ASR 118, the release in which it is found – the adopting release for money market fund reform – is not similarly being rescinded. We urge the Commission to clarify that a board that has assigned fair valuation to the adviser, and hence has also assigned direct oversight of pricing services to the adviser, need not engage in its own oversight at this level of detail, but rather oversee the adviser's use of pricing services in the context of its broader oversight of the adviser's fair valuation program.

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[10] *Id.* at 28744.

[11] *Id.* at 28740.

[12] *See* Money Market Fund Reform, Release No. 33-9616 (File No. S7-03-13), 49 Fed. Reg. 47736 at 47814-15 (Aug. 14, 2014).

D. **Lack of a Safe Harbor**

Unlike many Commission rules, proposed rule 2a-5 is not structured as a safe harbor. Absent any discussion of the lack of a safe harbor provision in the release, it appears that the Commission intends the rule to be the exclusive means by which boards can satisfy their statutory fair valuation obligations.

While, as detailed above, we support the broad approach that the Commission has taken in this rulemaking, it is not apparent that there should be only one way in which a board can satisfy its obligation to determine in good faith the fair value of a security for which a market quotation is not available. Indeed, as the Proposing Release recognizes, fund boards today take a variety of approaches to fair valuing such securities, most if not all of which presumably satisfy the statutory good faith standard.

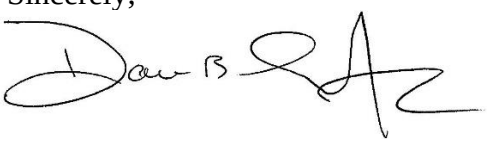
The lack of a safe harbor becomes even more notable if the Commission retains detailed requirements regarding the structure of fair valuation programs, the nature of board oversight and the content and frequency of adviser reporting to the board regarding its fair valuation programs. Potentially, the failure to meet even a small part of these sometimes administrative requirements would cause boards to fall outside the rule, and hence subject them to claims that they had not met their statutory obligation, even though the fund's fair valuation program was operating effectively and in the interest of shareholders. We encourage the Commission to address this and similar concerns by structuring the rule as a safe harbor.

V. Conclusion

In conclusion, we welcome the Commission's proposal on the fair valuation process. Broadly speaking, this proposal is extremely helpful, as it sets forth a coherent statement of the Commission's expectations on fair valuation, defines the respective roles of the board and the adviser, and provides certainty to boards regarding their legal obligations. That said, as described in our comments, we believe that the Commission should provide boards with greater discretion to structure their oversight role rather than attempting to prescriptively define how board reporting and the related oversight will function.

Again, we commend the Commission for undertaking to address this difficult but important subject. We would welcome the opportunity to further discuss our comments with you. Please feel free to contact Carolyn McPhillips, the Forum's President, at 202-507-4493 or David Smith, our General Counsel, at 202-507-4491 at any time.

Sincerely,



David B. Smith, Jr.
General Counsel