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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210 and 270

[Release No. IC-34128; File No. S7-07-20]

RIN 3235-AM71

Good Faith Determinations of Fair Value

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting a new rule under the Investment Company Act of 1940 ("Investment Company Act" or the "Act") that will 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 ("fund"). The rule will provide requirements for determining fair value in good faith for purposes of the Act. This determination will involve assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; and overseeing and evaluating any pricing services used. The rule will permit a fund's board of directors to designate certain parties to perform the fair value determinations, who will then carry out these functions for some or all of the fund's investments. This designation will be subject to board oversight and certain reporting and other requirements designed to facilitate the board's ability effectively to oversee this party's fair value determinations. The rule will 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 rule will also define when market quotations are readily available under the Act. The Commission is also adopting a separate rule providing the recordkeeping requirements that will be associated with fair value determinations and is rescinding previously issued guidance on the role of the board of directors in determining fair value and the accounting and auditing of fund investments.

DATES: *Effective date:* This rule is effective [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. *Compliance dates:* The applicable compliance dates are discussed in section II.G of this rule.

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SUPPLEMENTARY INFORMATION: The Commission is adopting 17 CFR 270.2a-5 (new rule 2a-5) and 17 CFR 270.31a-4 (new rule 31a-4) under the Investment Company Act.

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I. INTRODUCTION

The Investment Company Act requires funds to value their portfolio investments using the market value of their portfolio securities when market quotations are "readily available," and, when a market quotation for a portfolio security is not readily available or if the investment is not a security, by using the investment's fair value, as determined in good faith by the fund's board.[1] Proper valuation, among other things, promotes the purchase and sale of fund shares at fair prices, and helps to avoid dilution of shareholder interests.[2] Improper valuation can cause investors to pay fees that are too high or to base their investment decisions on inaccurate information.[3] We are adopting new 17 CFR 270.2a-5 ("rule 2a-5" or "final rule") in response to the developments in markets and fund investment practices since the Commission last

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[1] Section 2(a)(41) of the Investment Company Act. *See also* 17 CFR 270.2a-4 ("rule 2a-4"). 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. 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 this 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 rescission of the accounting guidance.

[2] *See* Good Faith Determinations of Fair Value, Investment Company Act Release No. 33845 (Apr. 21, 2020) [85 FR 28734 (May 13, 2020)] ("Proposing Release"), at n.2.

[3] *See Id*. at nn.1-11 and accompanying text.

comprehensively addressed valuation 50 years ago. These include developments in the accounting and auditing literature,[4] the growing complexity of valuation, and intervening regulatory developments such as the development of ASC Topic 820 and the interplay of 17 CFR 270.38a-1 ("rule 38a-1" or "the compliance rule") in facilitating board oversight of funds and the valuation process.[5] In addition, 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 challenges.[6] For example, funds that invest primarily in fixed income instruments (which may require fair value determinations for some or all of the portfolio assets) have expanded from around $800 billion in assets to over $4.5 trillion in just the last 20 years.[7]

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4 *See* Securities and Exchange Commission Codification of Financial Reporting Policies, Statement Regarding "Restricted Securities," Investment Company Act Release No. 5847 (Oct. 21, 1969) [35 FR 19989 (Dec. 31, 1970)], Financial Reporting Codification (CCH) section 404.04 (Apr. 15, 1982) ("ASR 113"); Investment Companies, Investment Company Act Release No. 6295 (Dec. 23, 1970) [35 FR 19986 (Dec. 31, 1970)], Financial Reporting Codification (CCH) section 404.03 (Apr. 15, 1982) ("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.

5 *See* Proposing Release, *supra* footnote 2, at nn.17-31 and accompanying text.

6 *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 (Nov. 25, 2019) [85 FR 4446 (Jan. 24, 2020)] (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) [76 FR 55237 (Sept. 7, 2011)], at 69 (noting that "[v]aluation of some derivatives may present special challenges for funds"); *see also* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 34084 (Nov. 2, 2020) [85 FR 83162 (Dec. 21, 2020)] ("Derivatives Adopting Release") at n.1 and accompanying text. 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 September 11, 2020, there were 12,680 open-end funds registered with the Commission with total net assets of over $27 trillion. *See infra* footnotes 496 through 497 and accompanying text. Moreover, as of September 2020, there were 97 business development companies ("BDCs") with $62 billion in total net assets. *See infra* footnote 497 and accompanying text. BDCs, which did not exist in 1970, must invest at least 70% of their assets in certain investments, which may be difficult to value. *See* section 55(a) of the Act.

7 *See* 2020 Investment Company Institute Fact Book at data table 3 *available at* https://www.icifactbook.org/data/20_fb_data. *See also* Proposing Release, *supra* footnote 2 (discussing the fund industry changes since the issuance of ASR 113 and 118).

We proposed rule 2a-5 in April 2020 and received more than 60 comment letters on the proposal.[8] Most commenters supported the Commission's goal of modernizing the regulatory framework for fund valuations.[9] Commenters generally agreed that the proposed framework for making a fair value determination was reasonable and consistent with current practice, but several requested additional flexibility regarding certain proposed requirements.[10]

We are adopting rule 2a-5 and companion 17 CFR 270.31a-4 ("rule 31a-4" and, together with rule 2a-5, the "rules") with certain modifications from the proposal to address the comments we received, including targeted revisions to address issues noted with respect to certain of the more prescriptive elements of the proposed rule. We are also rescinding the Commission's previously issued guidance on the role of the board of directors in determining fair value and the accounting and auditing of fund investments as proposed and, in a change from the proposal, are superseding certain of the guidance on thinly traded securities and the use of pricing services the Commission issued in 2014.[11]

II. DISCUSSION

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8 *See* Proposing Release, *supra* footnote 2. The comment letters on the Proposing Release (File No. S7-07-20) are available at https://www.sec.gov/comments/s7-07-20/s70720.htm.

9 *See, e.g.,* Comment Letter of Fidelity Investments (July 21, 2020) ("Fidelity Comment Letter"); Comment Letter of the American Bar Association (July 20, 2020) ("ABA Comment Letter"); Comment Letter of Franklin Resources, Inc. (July 21, 2020) ("Franklin Comment Letter"); Comment Letter of Charles E. Andrews, James G. Ellis, Pablo R. González Guajardo, Vanessa C. L. Chang, John G. Freund, and Christopher E. Stone (July 21, 2020) ("American Fund Trustees Comment Letter"); Comment Letter of the New York City Bar Association (July 21, 2020) ("NYC Bar Comment Letter"). However, some commenters objected to the proposal. *See* Comment Letter of Douglas Scheidt (May 29, 2020) ("Scheidt Comment Letter 1") and (June 29, 2020) ("Scheidt Comment Letter 2"); Comment Letter of Michael Cohan, David Jessup, Jr., and Shenghang Jiang (July 21, 2020) ("University of Miami Comment Letter").

10 *See, e.g.,* Comment Letter of J.P. Morgan Asset Management (July 15, 2020) ("JPMAM Comment Letter"); Comment Letter of the Vanguard Group (July 21, 2020) ("Vanguard Comment Letter"); Comment Letter of the Investment Company Institute (July 16, 2020) ("ICI Comment Letter"); Comment Letter of the Asset Management Group of the Securities Industry and Financial Markets Association (July 21, 2020) ("SIFMA AMG Comment Letter"); Comment Letter of Capital Research and Management Company (July 21, 2020) ("Capital Group Comment Letter").

11 Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014) [79 FR 47736 (Aug. 14, 2014)] ("2014 Money Market Fund Release").

The final rule provides 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.[12] We believe that, in light of the developments discussed above and in the Proposing Release, 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 the final rule establishes.[13]

Under the final rule, fair value as determined in good faith will require assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; and overseeing and evaluating any pricing services used. 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.

The final rule also permits a fund's board[14] to designate a "valuation designee" to perform fair value determinations.[15] The valuation designee can be the adviser of the fund or, in a change from the proposal, an officer of an internally managed fund.[16] When a board designates the performance of determinations of fair value to a valuation designee for some or all of the fund's investments under the final rule, the final rule requires the board to oversee the valuation designee's performance of fair value determinations. To facilitate such oversight, the final rule also includes certain reporting and other requirements.[17] The final rule acknowledges that,

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12 The final rule defines a "fund" as a registered investment company or a business development company. Rule 2a-5(e)(1).

13 One commenter stated that rule 2a-5 does not require the Commission to exercise its exemptive authority under section 6(c). Comment Letter of Jack Murphy (July 20, 2020) ("Murphy Comment Letter"). We agree and are relying on our authority under other provisions of the Investment Company Act, including our authority under section 38(a) of the Act, to adopt rule 2a-5. In any event, we believe the final rule's provisions are necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the Act. Accordingly, we believe section 6(c) also provides additional authority for the final rule.

14 For purpose of the final 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. Rule 2a-5(e)(3).

15 *See infra* footnotes 138–140 and accompanying text (discussing the change from the proposed "assign" to the term "designate" in the final rule).

16 Rule 2a-5(e)(4).

17 Rule 2a-5(b).

consistent with longstanding practice, these valuation designees often play an important and valuable role in carrying out the day-to-day work of determining fair values. Under the final rule, the board remains responsible for the fair value determinations required by the statute. Where the board designates a valuation designee to perform fair value determinations under the final rule, the board will fulfill its continuing statutory obligations through active oversight of the valuation designee's performance of fair value determinations and compliance with the other requirements of the final rule.[18]

Also, as proposed, the final rule applies to all registered investment companies and BDCs, regardless of their classification or sub-classification (*e.g.*, open-end funds and closed-end funds[19]), or their investment objectives or strategies (*e.g.*, equity or fixed income; actively managed or tracking an index).[20] In the case of a unit investment trust ("UIT"), because a UIT does not have a board of directors or adviser, a UIT's trustee, or, in a change from the proposal, the UIT's depositor must conduct fair value determinations under the final rule.[21]

While many commenters thought that the proposal's general approach of balancing between prescriptive requirements and principles-based guidelines was reasonable, others

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18 One commenter stated his belief that the Commission would need to use exemptive authority to "shift[] the statutory fair valuation responsibilities" away from fund directors. Scheidt Comment Letter 2. *But see* Murphy Comment Letter. As discussed above, we emphasize that the final rule does not in fact shift the statutory fair valuation responsibilities away from directors. Rather, the final rule establishes the requirements the board must meet to fulfill its continuing statutory obligations.

19 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.

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

21 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 (Mar. 9, 1987) [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.E (rescission of staff guidance).

requested modifications.[22] A number of commenters recommended that the Commission recast the proposed rule as a non-exclusive safe harbor or provide additional flexibility.[23] Some stated that they believed that fair value in good faith is a flexible concept, and thus they believed that fair value determinations are not amenable to a single approach, which they believed was consistent with the flexible approach taken in ASR 118.[24]

In light of the developments since the Commission last comprehensively addressed fair value determinations for funds, we believe that it is important to establish a minimum and consistent framework for fair value practices across funds. This framework also allows the Commission to articulate appropriate oversight measures, as outlined in section II.B below,[25] that are designed to help address valuation risks, including those arising from conflicts of interest.[26] The final rule establishes minimum and baseline standards that we believe are inherent in any good faith fair value determination, as informed by current industry practice. If we were to establish a safe harbor, in contrast, it may give the misleading impression that an approach to making fair value determinations that does not meet this minimum baseline would satisfy the

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22 *See, e.g.,* JPMAM Comment Letter; Vanguard Comment Letter; Comment Letter of State Street Global Advisors (July 21, 2020) ("SSGA Comment Letter"); Comment Letter of Baillie Gifford Funds (July 21, 2020) ("Baillie Gifford Comment Letter").

23 *See, e.g.,* Comment Letter of Arthur E. Johnson, Chairman of Independent Trustees, Fidelity Fixed Income and Asset Allocation Funds and David M. Thomas, Co-Lead Independent Trustee, Fidelity Equity and High Income Funds (June 26, 2020) ("Fidelity Trustees Comment Letter"); ICI Comment Letter; Comment Letter of Ronald E. Toupin, Board Chair, Guggenheim Funds (July 20, 2020) ("Guggenheim Trustees Comment Letter"); Catherine L. Newell, General Counsel and Executive Vice President, Dimensional Fund Advisers (July 27, 2020) ("Dimensional Comment Letter"); Comment Letter of Dechert LLP (July 21, 2020) ("Dechert Comment Letter"); Comment Letter of David B. Smith, General Counsel, Mutual Fund Directors Forum (July 21, 2020) ("MFDF Comment Letter").

24 *See* ICI Comment Letter; Fidelity Trustees Comment Letter; Guggenheim Trustees Comment Letter; Dimensional Comment Letter; Dechert Comment Letter. *See also* ASR 118 and Letter to Craig S. Tyle, General Counsel, Investment Company Institute (Dec. 8, 1999) and *infra* footnote 386 and accompanying text.

25 Throughout this release, when we refer to "appropriate" oversight, we mean oversight consistent with the guidance set out *infra* in section II.B.1.

26 As stated in the Proposing Release, 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 final rule. *See* Proposing Release, *supra* footnote 2, at 14-15.

board's statutory obligations.[27] The final rule does not establish a single approach to making such determinations. Instead, it establishes a principles-based framework for boards to use in creating their own specific process for making fair value determinations, including through designating and appropriately overseeing a valuation designee to perform certain valuation tasks.[28] It reflects an appropriate balance between providing a board or valuation designee with the flexibility to exercise judgment in the valuation process consistent with its good faith, paired with an appropriate set of baseline standards. Accordingly, we do not think that it is appropriate to recast rule 2a-5 as a safe harbor. However, we do agree with commenters that additional flexibility is appropriate in certain areas and have made a number of changes from the proposal in this regard, as discussed below.[29]

In support of a safe-harbor approach, some commenters raised concerns that violations of the proposed rule that may not directly impact the value given to an asset, for example a failure to keep records for the prescribed period, could raise doubts about whether a valuation was made consistent with the requirements of the Act. These commenters stated that this would be true even where the end result of the actual valuation was appropriate.[30] In response to these concerns, as discussed below, we are tailoring certain of the proposed reporting requirements and moving the proposed recordkeeping requirements out of rule 2a-5 and into a separate rule under the Act.[31] While a board or adviser's failure to comply with the final rule's requirements may

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27 We do not believe that establishing a baseline for making fair value determinations detracts from, or is at odds with, the board's fiduciary duty. Nothing in this rulemaking should be construed as abrogating or limiting any of the fiduciary duties that boards owe to funds. *See, e.g.*, section 36(a) of the Act; *Burks v. Lasker*, 441 U.S. 471, 484-85 (1970).

28 *See also* Fidelity Comment Letter (approving of the proposed approach of describing the process that must be followed rather than the describing with specificity the substantive elements of a proper fair value determination); ICI Comment Letter (appreciating that the Commission has not prescribed detailed methodological or investment-specific valuation guidance and instead emphasized process, reporting, and oversight).

29 *See*, *e.g.*, *infra* section II.B.2.

30 *See, e.g.*, Comment Letter of Stradley Ronon Stevens Young, LLP (July 21, 2020) ("Stradley Comment Letter"); Comment Letter of Guggenheim Investments (July 21, 2020) ("Guggenheim Comment Letter"); Dechert Comment Letter.

31 *See infra* section II.C.

call into question the effectiveness of the fund's fair value process and its compliance program, the Commission underscores that the objective of the final rule is to ensure that a fund's assets are properly valued. A violation of the final rule does not necessarily mean that the actual values ascribed to particular fund investments were in fact inappropriate, or, for example, that the fund has violated rule 22c-1.

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

Rule 2a-5 sets forth certain required functions that must be performed to determine the fair value of the fund's investments in good faith.[32] As discussed below, we are adopting these required functions substantially as proposed, with several changes from the proposal based on the comments the Commission received.

1. Periodically Assess and Manage Valuation Risks

We are adopting, as proposed, the requirement to assess periodically any material risks associated with the determination of the fair value of the fund's investments, including material conflicts of interest, and to manage those identified valuation risks.[33] Also as proposed, the final rule does not identify other specific valuation risks that may need to be addressed under this requirement or establish a specific re-assessment frequency.

Several commenters expressed general support for the valuation risk requirement,[34] with others suggesting certain modifications, particularly regarding whether the final rule should prescribe a frequency for the proposed periodic re-assessment of the fund's material valuation risks.[35] One commenter opposed the proposed requirement entirely, and suggested that the

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[32] As proposed, these requirements will apply to a fund's board that is determining fair value or, if the board designates a valuation designee to perform any fair value determinations as discussed below, to that party.

[33] 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.

[34] *See* Comment Letter of Valuation Research Corporation (July 21, 2020) ("VRC Comment Letter"); Murphy Comment Letter.

[35] *See, e.g.*, Comment Letter of Sullivan & Worcester LLP (June 8, 2020) ("Sullivan Comment Letter") (suggesting requirement of annual re-assessment of valuation risks); Comment Letter of the International

Commission remove references to valuation risk from the proposed rule, on the basis that identified valuation risks should have no impact on the actual fair valuing of particular fund investments, and that this requirement thus would unnecessarily complicate the final rule while providing no investor protection benefit.[36]

After considering these comments, we continue to believe that requiring the assessment and management of material valuation risks in the final rule will help promote an effective overall process for fair valuing fund investments in good faith.[37] With respect to the frequency of the required periodic re-assessment of valuation risks, we continue to believe that different frequencies for the re-assessment of valuation risks may be appropriate for different funds or risks, and have determined not to modify the proposed rule to include a required minimum frequency. We also continue to believe, as stated in the Proposing Release, 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.[38]

The Proposing Release also included a non-exhaustive list of examples of sources or types of valuation risk.[39] As discussed below, we are reiterating this non-exhaustive list here,

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Valuation Standard Council (July 14, 2020) ("IVSC Comment Letter") (same); *but see* ABA Comment Letter (stating that valuation policies and procedures, including procedures for re-assessment of valuation risks, would be subject to annual review under rule 38a-1, and recommending no minimum frequency in final rule).

36 *See* Franklin Comment Letter. For the same reasons, this commenter also suggested that we remove the proposed requirement that the adviser periodically report to the board on material changes to the assessment and management of valuation risks, including conflicts of interest. As discussed in section II.B.2.a below, the final rule includes periodic reporting on material changes in the assessment and management of valuation risks.

37 The final rule will require, among other things, that the board or valuation designee, as applicable, take into account the fund's valuation risks in establishing and applying fair value methodologies and, where the board has designated the valuation designee to perform fair value determinations, periodic reporting on material changes in the management and assessment of valuation risks, as discussed in section II.B.2.a) below. *See* rule 2a-5(a)(2).

38 *See* Proposing Release, *supra* footnote 2, at section II.A.1.

39 *See id.*

with several modifications to broaden the examples to include additional sources and types of risk raised by commenters.

We received a number of comments on the list of sources and types of valuation risk. One commenter expressed general support for the inclusion of this list, including its level of generality in describing sources and types of risk.[40] One commenter, on the other hand, stated that this list would cause confusion because funds cannot anticipate how the identified sources and types of valuation risk will affect the valuation of particular investments.[41] One commenter stated that the text of the final rule should identify specific valuation risks (similar to the non-exhaustive list discussed in the Proposing Release) that a board or adviser, as applicable, must assess and manage.[42] Other commenters recommended that the Commission identify additional sources and types of valuation risks.[43]

One commenter recommended we clarify that the assessment and management of valuation risks other than those identified in the Proposing Release can satisfy this requirement.[44] Similarly, one commenter suggested we clarify that some sources or types of valuation risk may be considered more or less important than others based on a particular fund's investments, the markets in which its investments trade, reliance on third-party service providers, and other relevant circumstances.[45]

After considering these comments, we continue to believe that a fund's specific valuation risks depend on the facts and circumstances of the particular fund's investments. As such, we

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40 *See, e.g.*, Murphy Comment Letter.

41 *See* Franklin Comment Letter (questioning whether funds should be expected to anticipate "potential market shocks or dislocations" in fair valuing their investments). *See also* ABA Comment Letter (stating that a board or adviser's assessment of valuation risks cannot account for potential future events, such as potential market shocks or dislocations that could change the assessment or management of valuation risk).

42 *See* University of Miami Comment Letter.

43 *See, e.g.*, Comment Letter of IHS Markit (July 21, 2020) ("IHS Markit Comment Letter") (stating that additional risks include the market structure for the asset); Murphy Comment Letter (stating that additional risks include the possibility that an adviser or third-party service provider will be unable to operate).

44 *See* Stradley Comment Letter.

45 *See* ABA Comment Letter.

believe that the non-exhaustive list of examples of sources and types of valuation risk, set forth below, is appropriate. As we stated in the Proposing Release, the risks identified are not intended to be a comprehensive list of all possible sources of valuation risk, but a set of examples that may help inform fund boards and valuation designees. We agree that the additional risks identified by commenters may also be relevant for certain funds, and have broadened the list provided below in several respects to include those risks. The final rule, like the proposal, is designed to provide a board or valuation designee, as applicable, with the flexibility to determine which of the identified sources and types of valuation risk are relevant to the fund's investments, as well as to identify other risks not listed here. The final rule also provides flexibility to determine whether certain sources and types of valuation risk should be weighed more heavily than others.

As such, the following is a non-exhaustive list of sources or types of valuation risk:

- The types of investments held or intended to be held by the fund[46] and the characteristics of those investments;[47]
- Potential market or sector shocks or dislocations and other types of disruptions that may affect a valuation designee's or a third-party's ability to operate;[48]
- The extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the valuation designee;[49]

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46 We recognize that in assessing and managing this potential source of valuation risk, a board or valuation designee, as applicable, may not be able to identify all of the types of investments the fund will hold or the specific valuation risks related to such investments. This risk assessment and management generally should take into account those investments that the fund reasonably expects to purchase in the reasonably near term.

47 Investment characteristics would include among other things, the size of the investment relative to measures of market demand, such as daily trading volume.

48 Indicators of potential 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. Additional types of disruptions that may affect a valuation designee's or a third-party's ability to operate include, for example, a system failure or cyberattack.

49 *See infra* footnotes 354–355 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.

2. Establish and Apply Fair Value Methodologies

As proposed, the final rule will provide that fair value as determined in good faith requires the board or valuation designee, as applicable, to establish and apply fair value methodologies. To satisfy this requirement, a board or valuation designee, as applicable, must:

(1) Select and apply appropriate fair value methodologies;

(2) Periodically review the appropriateness and accuracy of the methodologies selected and make any necessary changes or adjustments thereto; and

(3) Monitor for circumstances that may necessitate the use of fair value.

As discussed below, we are adopting these functions substantially as proposed, with certain modifications to respond to commenters' concerns and suggestions.

a) Select and Apply Appropriate Fair Value Methodologies

The final rule will require the board or valuation designee, as applicable, to select and apply in a consistent manner an appropriate methodology or methodologies[50] for determining

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[50] As the Commission stated in the Proposing Release, 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 Adopting 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.

(which includes calculating) the fair value of fund investments.[51] As proposed, to satisfy this requirement, the board or valuation designee, as applicable, will have to specify the key inputs and assumptions specific to each asset class or portfolio holding.[52] We are, however, modifying the requirement to select and apply appropriate methodologies in the final rule in two ways to address commenter concerns and suggestions. First, the final rule will provide that the selected methodologies for fund investments may be changed if different methodologies are equally or more representative of the fair value of the investments. Second, the final rule will not require the specification of methodologies that will apply to new types of investments in which the fund intends to invest.

We received numerous comments on the proposed requirement that the board or adviser, as applicable, select and apply in a consistent manner an appropriate methodology or methodologies for determining (which includes calculating) the fair value of fund investments. These commenters generally requested clarification relating to the proposed requirement that a board or adviser, as applicable, select and apply fair value methodologies "in a consistent manner." Several commenters stated that this proposed requirement suggested that a board or adviser, as applicable, generally may select only one methodology per asset class, and requested we clarify that this requirement does not preclude a board or adviser, as applicable, from selecting different methodologies for different securities within the same asset class or sub-class.[53] The final rule clarifies that this requirement is not meant to limit a board or valuation

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51 Proposing Release, *supra* footnote 2, at n.45 and accompanying text. As stated in the Proposing Release, 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).

52 *See* rule 2a-5(a)(2)(i).

53 *See, e.g.*, ICI Comment Letter; Sullivan Comment Letter; Murphy Comment Letter; Comment Letter of MFS Investment Management (July 21, 2020) ("MFS Comment Letter"); Comment Letter of John Hancock Investment Management LLC (July 21, 2020) ("John Hancock Comment Letter").

designee, as applicable, from using an appropriate methodology to fair value an investment, even if other investments within the same "asset class" are fair valued using a different appropriate methodology.

Similarly, commenters requested we clarify that the requirement to select and apply fair value methodologies in a consistent manner does not restrict a board's or adviser's ability to change the selected methodology for an investment or asset class under appropriate circumstances.[54] We recognize that there may be circumstances where it is appropriate to change a methodology if it would result in a measurement that is equally or more representative of fair value.[55] Accordingly, we have modified the final rule to clarify that the requirement to apply fair value methodologies in a consistent manner does not preclude the board or valuation designee, as applicable, from changing the methodology for an investment in such circumstances.[56] Applying a methodology consistently is not meant to lock in place a rigid pre-established methodology, but instead to address the risks associated with switching methodologies in order to achieve a specific outcome. Accordingly, the consistent application of appropriate methodologies allows for a board or valuation designee, as applicable, to select and apply a different methodology or methodologies for investments in the same asset class, or to change the methodology selected for one or more particular investments, based on changes to the facts and circumstances related to the particular investment if different methodologies are equally or more representative of the fair

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54 *See, e.g.*, Sullivan Comment Letter; IVSC Comment Letter; JPMAM Comment Letter; Comment Letter of Seward & Kissel LLP (July 20, 2020) ("Seward & Kissel Comment Letter"). For this reason, two commenters also suggested that we remove this term from the final rule. *See* Franklin Comment Letter; Comment Letter of Federated Hermes, Inc. (July 21, 2020) ("Federated Hermes Comment Letter").

55 *See* ASC Topic 820-10-35-25 (requiring consistent application of valuation techniques, but providing that a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances).

56 *See* rule 2a-5(a)(2)(i).

value of the investments.[57] Any change in methodology must be documented under the applicable recordkeeping requirements.[58]

Commenters questioned our statement in the Proposing Release that to be appropriate under rule 2a-5, a methodology used for purposes of determining fair value must be consistent with ASC Topic 820,[59] and thus must be derived from one of the principles-based approaches described therein.[60] Some of these commenters suggested that ASC Topic 820 is not appropriately tailored to address all of the specific circumstances that may arise for a fund that values its assets daily, and stated that we should either provide more specific guidance for certain funds or investments,[61] or not limit appropriate methodologies to those addressed in ASC Topic 820.[62]

We believe that an appropriate methodology must be consistent with those used to prepare the fund's financial statements and thus be consistent with the principles of the valuation approaches laid out in ASC Topic 820. Therefore, if a valuation methodology was used that is not consistent with the principles of the valuation approaches laid out in ASC Topic 820, we would presume that use of such a methodology would be misleading or inaccurate. While the valuation approaches laid out in ASC Topic 820 may not directly address every situation that a fund may face because the accounting standards are principles-based, we believe that taking a valuation approach that is inconsistent with the principles outlined in ASC Topic 820 may result

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57 A change includes using a new methodology or making a material adjustment to an existing methodology. *See* JPMAM Comment Letter.

58 *See* rule 31a-4(a). Furthermore, where the board has designated the valuation designee to perform fair value determinations, the final rule will require that the valuation designee periodically report to the board on material changes to, or material deviations from, the fair value methodologies established under this requirement. *See* rule 2a-5(b)(1)(i)(A)(*2*)(*ii*).

59 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. *See supra* footnote 50.

60 *See, e.g.*, NYC Bar Comment Letter; Scheidt Comment Letter 2.

61 *See* Scheidt Comment Letter 2.

62 *See* ABA Comment Letter.

in a fund having a misleading or inaccurate fair value process because such an approach may not be consistent with U.S. GAAP and the fund's financial reporting process. Supplemental methodologies for situations not explicitly outlined in ASC Topic 820 may be appropriately applied by boards or valuation designees provided that the methodologies are not inconsistent with the principles outlined in ASC Topic 820. We recognize 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.[63] 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. A consistent application of the selected methodology or methodologies, with changes to the methodology or methodologies where appropriate, together with the other provisions of the rules, would promote unbiased determinations of fair value within the range.

Commenters suggested we clarify that certain guidance provided in the 2014 Money Market Funds Adopting Release relating to the valuation of thinly traded securities is being superseded by final rule 2a-5 and the related guidance provided herein.[64] We believe that the guidance contained in this section addresses the same concerns discussed in the guidance contained in the last paragraph of the section on valuing thinly traded securities in the 2014 Money Market Funds Adopting Release.[65] Accordingly, that paragraph is superseded. As a general principle, determining fair value requires taking into account market conditions existing at the time of the determination. Accordingly, appropriate methodologies for funds holding debt

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63 This is consistent with what the Commission previously said in 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, the methodologies selected should maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

64 *See, e.g.*, Vanguard Comment Letter.

65 *See* 2014 Money Market Funds Release, *supra* footnote 11, at last paragraph of section III.D.2.a.

securities generally should not fair value these securities at par or amortized cost based on the expectation that the funds will hold those securities until maturity, if the funds could not reasonably expect to receive approximately that value upon the measurement date under current market conditions. We continue to believe that fair value cannot be based on what a buyer might pay at some later time, such as when the market ultimately recognizes the security's true value as currently perceived by the portfolio manager.[66] Funds also may not fair value portfolio securities at prices not achievable on a current basis on the belief that the fund would not currently need to sell those securities. We believe the principles established in ASC Topic 820, which provide that an investment is valued based on an exit price at the measurement date from the perspective of a market participant under current market conditions, are consistent with the statements in this paragraph.[67]

The proposed rule also would have required the board or adviser, as applicable, to 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.[68] This requirement was designed to facilitate the effective determination of the fair value of these new investments by the board or adviser, as applicable. While one commenter suggested that this requirement was appropriate as proposed,[69] other commenters generally opposed this requirement as being potentially overly burdensome by requiring boards and advisers to establish

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66 *See* 2014 Money Market Funds Release, *supra* footnote 11, at section III.D.2.a.

67 *See* ASC 820-10-35-3 and ASC 820-10-20 ("A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions."; Fair Value means "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"). *See also* ASC Topic 820, at par. 820-10-35-54H ("A reporting entity's intention to hold the asset or to settle or otherwise fulfill the liability is not relevant when measuring fair value because fair value is a market-based measurement, not an entity-specific measurement.").

68 Proposed rule 2a-5(a)(2)(i)(B).

69 *See* IHS Markit Comment Letter (stating that funds currently have processes in place to ensure that a methodology and supporting pricing service provider are in place to cover new investments).

a predetermined list of methodologies to account for *all* types of new investments in which the fund may invest.[70]

We are persuaded that specifically requiring a predetermination of the methodologies that must be applied to hypothetical future investments could cause undue burdens to the extent it caused a fund to establish methodologies for assets in which a fund ultimately does not invest. Moreover, a fund will be required to value all of its investments, regardless of whether the fund had pre-determined a methodology. We believe that the general requirement under the final rule to select and apply in a consistent manner an appropriate methodology or methodologies for determining (and calculating) the fair value of fund investments,[71] will require a board or a valuation designee, where applicable, to determine which methodology is appropriate for a new investment type that a fund has actually purchased by the time the investments are valued. Accordingly, we have determined to remove from the final rule the proposed specific requirement that a board or adviser, as applicable, specify in advance the fair value methodologies that will apply to new types of investments in which the fund intends to invest.

b) Periodically Review the Appropriateness and Accuracy of the Methodologies Selected

To establish and apply fair value methodologies appropriately, the final rule will require a board or valuation designee to review periodically the selected fair value methodologies for appropriateness and accuracy, and to make changes or adjustments to the methodologies where necessary.[72] We are adopting this requirement substantially as proposed, with one modification, discussed below, to respond to a comment we received. In addition, as stated in the Proposing Release, the results of back-testing or calibration (as discussed below) or a change in

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70 *See, e.g.*, Sullivan Comment Letter; Seward & Kissel Comment Letter; ABA Comment Letter; VRC Comment Letter.

71 *See* rule 2a-5(a)(1).

72 *See* Proposing Release, *supra* footnote 2, at n.50 and accompanying text.

circumstances specific to an investment, for example, could necessitate adjustments to a fund's fair value methodologies.[73]

We received one comment on this requirement. The commenter generally supported it, but suggested we clarify that "adjustments" to the selected fair value methodologies under this requirement may include a change to new appropriate methodologies.[74] We agree, and have added the word "change" to the final rule to clarify that a necessary adjustment to the selected methodology under the final rule is not limited to modifying an existing methodology for a particular investment (for example, adjusting inputs), but also may include changing to a new methodology where appropriate.[75]

c) Monitor for Circumstances That May Necessitate the Use of Fair Value

As proposed, the final rule will also require the board or valuation designee, as applicable, to monitor for circumstances that may necessitate the use of fair value as determined in good faith.[76] For example, if a fund invests in securities that trade in foreign markets, the board or valuation designee, as applicable, generally should identify and monitor for the kinds of 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.[77]

One commenter generally requested we clarify that this requirement is not meant to require the board or valuation designee, where applicable, to identify in advance *all* of the

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[73] *Cf.* ASC Topic 820-10-35-25, which 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 valuation designees generally should seek to account for such occurrences and consider specifying alternative sources.

[74] *See* Murphy Comment Letter.

[75] *See supra* section II.A.2.a).

[76] Rule 2a-5(a)(2)(iii).

[77] *Cf.* ASC Topic 820-10-35-41C(b).

circumstances that may require the use of fair value.[78] While we agree that the circumstances that may necessitate fair value depend on the facts and circumstances of the particular fund's investments and that certain of these circumstances cannot be established in advance, we also believe that monitoring for circumstances that may require the use of fair value is an important element of an effective overall process for determining fair value in good faith.

The proposed rule also would have required the establishment of criteria for determining when market quotations are no longer reliable and therefore not readily available.[79] One commenter viewed this proposed requirement as potentially being overly restrictive of boards' and advisers' discretion to question the reliability of market quotations, and suggested we remove it from the final rule.[80] Another commenter suggested that requiring a board or adviser to identify in advance all of the criteria indicating when a market quotation may not be reliable would be overly burdensome.[81]

Although this requirement derived from the Commission's positions under the compliance rule,[82] we have determined to remove it from the final rule. We agree with commenters that requiring, in advance, a list of specific *criteria* for determining when market quotations may no longer be reliable could limit the board's or valuation designee's flexibility to consider the full range of conditions that may affect the reliability of market quotations. In addition, we believe that to satisfy the requirement to monitor for circumstances that may necessitate the use of fair value, discussed above, boards and valuation designees would have to take into account the circumstances that may cause market quotations to be no longer reliable.

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78 *See* John Hancock Comment Letter.

79 Proposed rule 2a-5(a)(2)(iv).

80 *See* Sullivan Comment Letter.

81 *See* John Hancock Comment Letter.

82 *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 FR 74713 (Dec. 24, 2003)] ("Compliance Rules Adopting Release").

The final rule, however, will not require those broader circumstances to be captured in specific criteria.

3. Test Fair Value Methodologies for Appropriateness and Accuracy

As proposed, the final rule will require the testing of the appropriateness and accuracy of the methodologies used to calculate fair value.[83] 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. The final rule, similar to the proposal, will require the board or valuation designee, as applicable, to identify the testing methods to be used and the minimum frequency with which such testing methods are used, but will not require particular testing methods or a specific minimum frequency for the testing.

While several commenters supported the proposed requirement,[84] other commenters recommended that we modify or clarify the requirement in the final rule. One commenter recommended that we remove from the final rule the proposed requirement that the adviser or board identify the testing methods to be used and the minimum frequency with which such testing methods are used, viewing it as overly prescriptive and too limiting of the discretion of the board or adviser, as applicable, to determine how testing should be conducted.[85] Several commenters recommended we clarify that parties other than the board or adviser, as applicable, such as pricing services, may perform the testing.[86] One commenter asked that we provide a de minimis exception to the proposed testing requirement for funds that have a limited amount of

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83 Rule 2a-5(a)(3).

84 *See, e.g.*, Baillie Gifford Comment Letter; Capital Group Comment Letter; Comment Letter of Invesco Advisers, Inc. (July 21, 2020) ("Invesco Comment Letter").

85 *See* Franklin Comment Letter.

86 *See* ICI Comment Letter; IHS Markit Comment Letter; Comment Letter of New York State Society of Certified Public Accountants (Jul. 22, 2020) ("NYSSCPA Comment Letter"). We received several comments generally requesting that we clarify that the board or adviser, where applicable, may engage third parties to assist with fair value determinations. Those comments are addressed below in section II.B relating to guidance on assistance of others.

fair valued investments.[87] Finally, one commenter recommended that the final rule require that methodology testing be performed at least quarterly or whenever the fund provides financial statements to investors.[88]

After considering these comments, we continue to 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 valuation designee, as applicable. We also continue to believe that requiring the identification of (1) the testing methods to be used, and (2) the minimum frequency of the testing, is appropriate and still provides boards and valuation designees with flexibility to perform methodology testing based on the particular circumstances of a particular fund.[89] We believe that funds that have even a limited amount of fair valued investments should test their methodologies, and therefore are not providing a de minimis exception.[90] Testing can often reveal important information about the continuing appropriateness of a methodology. We expect the frequency and nature of testing would vary depending on the type and amount of investments held by the fund. If a specific methodology consistently over-values or under-values one or more fund investments as compared to observed transactions, the board or valuation designee, as applicable, should investigate the reasons for this difference.

Calibration and back-testing are examples of particularly useful testing methods to identify trends in certain circumstances, and potentially to assist in identifying issues with methodologies applied by fund service providers, including poor performance or potential

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87 *See* NYSSCPA Comment Letter.

88 *See* Comment Letter of CFA Institute (July 21, 2020) ("CFA Institute Comment Letter").

89 Calibration can assist in assessing whether the fund's valuation technique reflects current market conditions, and 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. *See* Proposing Release, *supra* footnote 2, at n.57.

90 *See* NYSSCPA Comment Letter.

conflicts of interest.[91] Several commenters recommended we clarify that this statement is not meant to suggest that calibration and back-testing are required testing methods, or that the use of appropriate testing methods other than calibration and back-testing would not satisfy the testing requirement.[92] While we believe that calibration and back-testing are methods that should be used for testing the appropriateness and accuracy of funds' fair value methodologies in many circumstances, the final rule does not require calibration and back-testing, nor does it preclude boards or valuation designees, where applicable, from using other appropriate testing methods.[93] We expect that as testing methodologies are developed and change over time, new and different tools for testing may also become more prominent or useful. The final rule provides flexibility to allow funds to use new, appropriate testing methods.

4. Pricing Services

As proposed, the final rule will provide that determining fair value in good faith requires the oversight and evaluation of pricing services, where used.[94] For funds that use pricing services, the final rule will require that the board or valuation designee, as applicable, establish a process for approving, monitoring, and evaluating each pricing service provider. The final rule also will require that the board or valuation designee, as applicable, establish a process for initiating price challenges as appropriate. Commenters generally supported the proposal to require the board or adviser, as applicable, to oversee and evaluate pricing services.[95] One

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91 As stated in the Proposing Release, 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 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. *See* Proposing Release, *supra* footnote 2, at n.58.

92 *See, e.g.*, Comment Letter of T. Rowe Price Associates, Inc. ("July 21, 2020) ("TRC Comment Letter"); SIFMA Comment Letter; CFA Institute Comment Letter.

93 We recognize, for example, that back-testing as a testing method may be less useful for portfolio holdings that trade infrequently. *See* Proposing Release, *supra* footnote 2, at n.59 and accompanying text.

94 Rule 2a-5(a)(4).

95 *See, e.g.* Comment Letter of Deloitte & Touche LLP (July 15, 2020) ("Deloitte Comment Letter"); Fidelity Trustees Comment Letter; John Hancock Comment Letter; ICI Comment Letter; Comment Letter of

commenter, however, stated that this oversight provision is unnecessary in the case of pricing services that are not affiliated with the fund's adviser.[96] This commenter stated that pricing services should not be distinguished from other third-party fund service providers, which advisers oversee to meet their own fiduciary obligations. Another commenter questioned the significance of a pricing service's conflicts of interest, stating that pricing services maintain relationships with a wide variety of investment advisers, and generally are expected to provide the same valuation information with respect to a particular security to all funds.[97] As a result, this commenter asserted that it would be less likely for a pricing service to be unduly pressured to provide favorable information in a particular scenario or to a particular investment adviser. We believe, however, that the conflict is not necessarily one of responding to pressure from a particular investment adviser, but, rather, a pricing service might generally provide higher or more aggressive valuations to retain business.

We believe, and many commenters agreed, that pricing services play an important role in the fair value process by providing information on evaluated prices, matrix prices, price opinions, or similar pricing estimates or information that can assist in determining the fair value of fund investments.[98] Additionally, we believe that pricing services may have conflicts of interest such as maintaining continuing business relationships with the valuation designee. Therefore, given the widespread reliance on pricing services, the critical role they play in the valuation of fund investments, and their potential conflicts of interests, regardless of whether

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Council of Institutional Investors (July 20, 2020) ("Council of Institutional Investors Comment Letter"); Comment Letter of AIMA (July 21, 2020) ("AIMA Comment Letter); Vanguard Comment Letter; Invesco Comment Letter; MFS Comment Letter; VRC Comment Letter; Guggenheim Comment Letter; TRP Comment Letter; IVSC Comment Letter; Comment Letter of Harvest Investments, Ltd. (July 21, 2020) ("Harvest Comment Letter"); Murphy Comment Letter.

96 Stradley Comment Letter.

97 John Hancock Comment Letter.

98 *See, e.g.* Fidelity Trustees Comment Letter; Deloitte Comment Letter. *See also* Capital Group Comment Letter (noting that more than 50% of the fund portfolios with non-US equity strategies may be subject to non-US price adjustments due to significant US market moves, which would require pricing services to provide a substantial amount of pricing information).

they are affiliated with the fund's adviser, the final rule will require that pricing services be subject to oversight so that the board or valuation designee, as applicable, has a reasonable basis to use the pricing information it receives as an input in determining fair value in good faith. To oversee pricing services effectively, the board or valuation designee, as applicable, should establish a process for the approval, monitoring, and evaluation of each pricing service provider used.

In a change from the proposal, we are modifying the final rule to require funds to establish a *process* for initiating price challenges as appropriate, instead of the proposed approach that would have required funds to establish *criteria* for the circumstances under which price challenges would be initiated.[99] Many commenters stated that requiring funds to establish specific criteria, such as objective thresholds, for price challenges was too rigid. Commenters were concerned that this would result in rote or mechanical price challenges that may be unnecessary, while not covering price challenges that may be appropriate based on facts and circumstances not readily susceptible to being distilled into criteria specified in advance.[100] Commenters stated that the circumstances under which a fund might initiate a price challenge are not always objective or based on set criteria given the myriad of different, and often fluid, data sources and inputs that could lead to challenges.[101]

After considering comments, we agree that there can be a range of circumstances under which a price challenge may be warranted, some of which cannot be distilled into specific criteria in advance.[102] For example, such an approach may lead the valuation designee to

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99 *See* Proposing Release, *supra* footnote 2, at text following n.63 (stating that price challenges are typically initiated when pricing information from a pricing service differs materially from the board's or adviser's view of the fair value of an investment).

100 *See e.g.,* ICI Comment Letter; JPMAM Comment Letter; John Hancock Comment Letter; Dechert Comment Letter; SIFMA AMG Comment Letter; TRP Comment Letter; Guggenheim Comment Letter; Comment Letter of Jon Hunt and Joseph T. Grause, Trustee and Lead Non-Interested Trustee, Advisors' Inner Circle Funds Trusts (July 23, 2020) ("Advisor's Inner Circle Trustees Comment Letter"); Murphy Comment Letter.

101 *See e.g.,* Capital Group Comment Letter; John Hancock Comment Letter.

102 *See e.g.,* ICI Comment Letter; Guggenheim Comment Letter; TRP Comment Letter.

challenge pricing information that is reasonable given market conditions, solely because such pricing information meets the pre-established criteria. We believe, however, that appropriate oversight of pricing services includes a rigorous analysis of the pricing information provided by pricing services and any price challenges, where appropriate. Therefore, we are amending this requirement to require that funds establish a process for initiating price challenges, instead of pre-established criteria.[103] Such a process generally should outline the circumstances under which a price challenge should be initiated.[104]

Several commenters urged the Commission to provide additional guidance concerning who would qualify as a pricing service under the final rule.[105] Two commenters stated that the term "pricing service" as used in the Proposing Release is not entirely consistent with the definition in the Public Company Accounting Oversight Board (PCAOB) standards for auditing fair value measurements.[106] We are not adopting a specific list of criteria for who may qualify as a pricing service because we believe that it may become outdated over time and that the scope of the term "pricing service" is generally understood by boards and valuation designees. However, as we stated in the Proposing Release, we refer to pricing services as third parties that regularly provide funds with information on evaluated prices, matrix prices, price opinions, or similar pricing estimates or information to assist in determining the fair value of fund investments.[107]

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103 *See e.g.* SIFMA AMG Comment Letter.

104 If the board designates a valuation designee to perform fair value determinations, the process for initiating price challenges established by the valuation designee is required to be subject to appropriate board oversight under rule 2a-5. *See infra* text accompanying footnotes 214-218 (noting that a valuation designee may have an incentive to value fund assets improperly in order to increase fees and that, therefore, as part of the board's oversight responsibilities, the board should seek to identify such potential conflicts of interest, monitor such conflicts, and take reasonable steps to manage such conflicts).

105 *See e.g.,* Comment Letter of Refinitiv Evaluated Pricing Service (July 21, 2020) ("Refinitiv Comment Letter"); Comment Letter of ICE Data Pricing & Reference Data, LLC (July 21, 2020) ("ICE Data Comment Letter"); Capital Group Comment Letter; AIMA Comment Letter; Comment Letter of KPMG (July 20, 2020) ("KPMG Comment Letter"); Comment Letter of Duffs and Phelps (July 21, 2020) ("Duff & Phelps Comment Letter"); Comment Letter of the American Society of Appraisers (July 21, 2020) ("ASA Comment Letter").

106 *See* KPMG Comment Letter; *see also* Duff & Phelps Comment Letter.

107 *See* Proposing Release, *supra* footnote 2, at text accompanying n.60.

We believe that the types of entities that would be pricing services under the final rule would include pricing services as defined in the PCAOB standards.[108]

Some commenters suggested we also include a specific requirement for a fund's board or adviser, as applicable, to periodically review the selection of pricing services and to evaluate other pricing services.[109] Two commenters, in contrast, stated that such a requirement would be unnecessary because the compliance rule already requires periodic reviews of service providers, including fund pricing services.[110] We believe that a specific requirement to review the selection of pricing services is unnecessary in light of the reporting requirements of rule 2a-5, discussed below.[111] We think that the board or the valuation designee should, as part of their annual review of the adequacy and effectiveness of the fair value process, consider the adequacy and effectiveness of the pricing services used given the important role that information provided by pricing services can play in the fair value process.

In addition, several commenters stated that the oversight of pricing services requirements under rule 2a-5 may not be consistent with previous guidance regarding the use of pricing services in the 2014 Money Market Fund Release, particularly regarding the role of the board of directors.[112] Some of these commenters urged us to rescind that guidance and holistically address oversight of pricing services in this Adopting Release.[113]

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108 *See* PCAOB AS 2501.

109 *See* Council of Institutional Investors Comment Letter; VRC Comment Letter; IHS Markit Comment Letter.

110 ICE Data Comment Letter; *see also* Refinitiv Comment Letter; Murphy Comment Letter. We disagree with these commenters. *See* Compliance Rules Adopting Release, *supra* footnote 82, at n.28 (stating that the term "service provider" as used in the Compliance Rules Adopting Release does not include pricing services).

111 *See infra* section II.B.2.

112 *See* MFDF Comment Letter; Fidelity Trustees Comment Letter; Comment Letter of Independent Directors Council (July 16, 2020) ("IDC Comment Letter"); NYC Bar Comment Letter; ABA Comment Letter; American Funds Trustees Comment Letter.

113 ABA Comment Letter; IDC Comment Letter; Fidelity Trustees Comment Letter. *See also* Advisor's Inner Circle Trustees Comment Letter (stating its belief that the list of factors set out in the Proposing Release exceeds what is reasonably necessary to oversee pricing services, and offering, as an example, that review

We believe that the requirements of the final rule and the guidance provided in this section effectively address the concerns with oversight of pricing services discussed as part of the fair value guidance in the 2014 Money Market Fund Release. We state below our views on how oversight and selection of pricing services may be effectively conducted, which is largely consistent with our previous guidance from the 2014 Money Market Fund Release guidance but reflects the process established in rule 2a-5 allowing the board to designate the valuation designee to perform fair value determinations.[114] The guidance below also includes certain additional factors that were included in the Proposing Release.[115] Our views stated below supersede the guidance the Commission expressed in the 2014 Money Market Fund Release regarding the use of pricing services, and so we are rescinding that guidance.[116]

We believe that under the final rule, before deciding to use a pricing service, the fund's board or valuation designee, as applicable, 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 assumptions[117] used by the pricing service for different classes of holdings, and how they are affected (if at all) as market conditions change;[118] (iii) the quality of

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of a pricing service's valuation methods or techniques, inputs and assumptions is inconsistent with the role of an overseer of pricing services). The specific factors with which the commenter had concerns were also included in the guidance in the 2014 Money Market Fund Release. We disagree with the commenter because we believe that a review of a pricing service's valuation methods or techniques, inputs, and assumptions is a necessary factor of effective oversight by the valuation designee or the board, as applicable.

114 *See* Proposing Release, *supra* footnote 2, at text following n.154 (requesting comment on whether the Commission should rescind any other valuation guidance in light of the proposal).

115 *See* Proposing Release, *supra* footnote 2, at text accompanying nn.62-63.

116 This rescission is limited to section III.D.2.b of the 2014 Money Market Fund Release entitled "Use of Pricing Services." The guidance in that release on the use of amortized cost valuation remains valid. *See also supra* footnotes 64-67 and accompanying text (discussing the rescission of certain guidance we provided in the 2014 Money Market Fund Release regarding thinly traded securities).

117 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 valuation designee or its affiliates. *See* Proposing Release, *supra* footnote 2, at n.62. *See also infra* section II.B.3.

118 Guidance in the 2014 Money Market Fund Release contained a similar position. *See, e.g.,* 2014 Money Market Fund Release, *supra* footnote 11, at text accompanying n.899.

the pricing information provided by the service and the extent to which the service determines its pricing information as close as possible to the time as of which the fund calculates its net asset value;[119] (iv) the pricing service's process for considering price challenges, including how the pricing service incorporates information received from price challenges into its pricing information; (v) the pricing service's actual and potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts;[120] and (vi) the testing processes used by the pricing service.[121] In addition, the fund's board or valuation designee, as applicable, should generally consider the appropriateness of using pricing information provided by a pricing service in determining the fair values of the fund's investments where, for example, the fund's board or valuation designee, as applicable, does not have a good faith basis for believing that the pricing service's pricing methodologies produce prices that reflect fair value.[122]

5. Fair Value Policies and Procedures

The final rule does not include the provision in the proposal that would have separately required the fund to adopt written policies and procedures reasonably designed to achieve compliance with the requirements of rule 2a-5.[123] While commenters generally supported this requirement,[124] other commenters argued that policies and procedures required by the proposed rule are already required by the compliance rule and urged the Commission to clarify the

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119 *Id.*

120 *See supra* footnote 97 and accompanying text (discussing the conflicts of interests of pricing services).

121 Factors (iv) through (vi) were included in the Proposing Release. *See* Proposing Release, *supra* footnote 2, at text accompanying nn.62-63.

122 The 2014 Money Market Fund Release contained a similar position. *See, e.g.,* 2014 Money Market Fund Release, *supra* footnote 11, at text accompanying n.899.

123 Proposed rule 2a-5(a)(5).

124 *See*, *e.g.*, Comment Letter of IDC Comment Letter (July 21, 2020) ("IAA Comment Letter"); Murphy Comment Letter; ICI Comment Letter; Invesco Comment Letter; AIMA Comment Letter; IVSC Comment Letter; Comment Letter of the Small Business Investor Alliance (July 21, 2020) ("SBIA Comment Letter"); ICE Data Comment Letter; Fidelity Comment Letter; Comment Letter of Richard Cavanagh and Karen Robards, Independent Co-Chairs of the Boards of Directors/Trustees of the Funds in the BlackRock Fixed-Income Complex (July 17, 2020) ("BlackRock Trustees Comment Letter"); ABA Comment Letter; Vanguard Comment Letter.

interaction between fund obligations under the compliance rule and the policies and procedures required under the proposed rule.[125]

Rule 38a-1 requires a fund's board, including a majority of its independent directors, to approve the fund's policies and procedures, and those of each 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.[126] We agree that, after our adoption of rules 2a-5 and 31a-4, the compliance rule by its terms will require the adoption and implementation of written policies and procedures reasonably designed to prevent violations of the requirements of rules 2a-5 and 31a-4 ("fair value policies and procedures").[127] Accordingly, final rule 2a-5 does not include a separate policies and procedures requirement.

While the adopting release for the compliance rule included a discussion of certain policies and procedures for determination of fair value that a fund should adopt, this discussion occurred prior to our adoption of rule 2a-5.[128] Rule 2a-5 creates a new framework for fair value determinations. As we stated in the Proposing Release, the requirements of rule 2a-5 and guidance in this release will supersede the Compliance Rules Adopting Release's discussion of policies and procedures for the pricing of portfolio securities and fund shares.[129] Accordingly, to comply with the compliance rule, each fund must adopt and implement fair value policies and procedures that are reasonably designed to prevent violations of new rules 2a-5 and 31a-4's requirements. Because rules 2a-5 and 31a-4 are new rules under the Act with new fair value

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125 *See, e.g.,* Seward & Kissel Comment Letter; ABA Comment Letter; Fidelity Comment Letter; NYC Bar Comment Letter. *See also* Stradley Comment Letter and Advisor's Inner Circle Trustees Comment Letter (noting that the proposed policies and procedures required under rule 2a-5 were duplicative and would be unnecessarily burdensome to boards).

126 17 CFR 270.38a-1(a)(2). *See also* Compliance Rules Adopting Release, *supra* footnote 82.

127 *See, e.g.,* Seward & Kissel Comment Letter; ABA Comment Letter; Fidelity Comment Letter; Advisor's Inner Circle Trustees Comment Letter; NYC Bar Comment Letter. *See* Compliance Rules Adopting Release, *supra* footnote 82, at nn.39-47.

128 *See* Compliance Rules Adopting Release, *supra* footnote 82, at nn.39-47.

129 *See* Proposing Release, *supra* footnote 2 at n.69.

determination requirements, and given the intrinsic relationship of the rules to the board's own statutory functions relating to valuation, the fair value policies and procedures must be approved by the board pursuant to rule 38a-1 and may not be considered material amendments to existing fair value policies and procedures.[130]

Where the board determines the fair value of investments, the fund will adopt and implement the fair value policies and procedures under the compliance rule.[131] Similarly, where the board designates the adviser as valuation designee to perform fair value determinations under rule 2a-5(b), as discussed in section II.B, the adviser will adopt and implement the fair value policies and procedures under the compliance rule. As with a fund adopting fair value policies and procedures, the adviser's fair value policies and procedures must be approved by the board pursuant to rule 38a-1 and may not be considered material amendments to existing fair value policies and procedures. This approach clarifies, as some commenters requested, that the board can fulfill its responsibilities under the compliance rule if the adviser adopts fair value policies and procedures without the need for the fund to adopt duplicative policies separately.[132] Additionally, we believe that this approach helps to ensure that fair value policies and procedures include an appropriate amount of detail, while preserving a certain level of flexibility for the

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130 Additionally, as discussed below, rule 2a-5 continues to contain certain board reporting requirements specifically tailored to the requirements of the final rule. While the compliance rule separately requires the fund's chief compliance officer ("CCO") to provide an annual report to the fund's board that addresses the operation of these policies and procedures, including any material changes to these policies and procedures, rule 2a-5's reporting requirements address a different set of concerns. *See* rule 38a-1(a)(4)(iii)(A). *See also* Compliance Rules Adopting Release, *supra* footnote 82.

131 For an internally-managed fund, the fair value policies and procedures will be adopted by the fund regardless of whether the board determines the fair value of investments itself or designates an officer of the fund to perform fair value determinations.

132 *See* Advisor's Inner Circle Trustees Comment Letter (requesting that the Commission clarify that a board can fulfill its responsibilities under rule 38a-1 by approving the adviser's fair value policies as reasonably designed to prevent violation of the Federal securities laws, without the investment company's having to "adopt" its own or the adviser's policies); NYC Bar Comment Letter. Furthermore, as we stated in the Proposing Release, 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 not be affected by the final rule.

board or adviser, as applicable, to tailor the fair value policies and procedures to the unique facts and circumstances of the fund.[133]

B. Performance of Fair Value Determinations

Largely as proposed, under the final 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 final rule, including, among other things, selecting and applying valuation methodologies.[134] A board could also designate the performance of fair value determinations relating to any or all fund investments to a valuation designee, subject to the board's oversight. The final rule will require the valuation designee to make certain reports to the board, specify responsibilities regarding fair value determinations, and reasonably segregate portfolio management from fair value determinations.[135] The trustee or depositor will generally perform the fair value functions in paragraph (a) of the final rule for UITs, which do not have a board or adviser.[136] These provisions are designed to provide boards, valuation designees, and other parties involved with a consistent approach to the allocation of fair value functions that recognizes the important role that valuation designees can play in the fair value process, while also preserving a crucial role for boards to fulfill their obligations under section 2(a)(41) of the Act by meeting the requirements of the final rule.[137]

Designate or Assign

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133 *See*, *e.g.*, SBIA Comment Letter; University of Miami Comment Letter; MFS Comment Letter; Vanguard Comment Letter; ABA Comment Letter; BlackRock Trustees Comment Letter (arguing that rule 2a-5 should give fund boards flexibility in developing fair value policies and procedures). *But see* IVSC Comment Letter (urging the Commission to consider requiring additional prescriptive elements that should be included in fair value policies and procedures).

134 In this circumstance, the fund would need to adopt and implement policies and procedures under rule 38a-1 to address valuation issues and keep records consistent with the requirements of the rules. *See* rules 2a-5(b), 31a-4, and 38a-1(a)(1).

135 Rule 2a-5(b).

136 Rule 2a-5(d). *See also infra* footnotes 178 through 180 and accompanying text (discussing the limited circumstance under which other parties may perform the requirements of paragraph (a) of the final rule for UITs).

137 Proposing Release, *supra* footnote 2, at 32.

Section 2(a)(41) requires that the board determine fair value for securities that do not have readily available market quotations. The final rule provides that the board may "designate" the performance of these fair value determinations to a valuation designee. This is a change from the proposal that would have provided that the board may "assign" such task to an adviser. Some commenters questioned the use of the phrase "assign" in the proposed rule, stating that it was unique in the rules adopted under the Act. These commenters stated that the scope of an assignment was unclear.[138] One such commenter observed that other terms, such as "designate," are used in other Commission rules and connote choosing a party for a particular purpose.[139] After considering comments, we believe that a board "designating" a valuation designee to perform fair value determinations better describes the relationship between the board and valuation designee under the final rule—that is, one where the valuation designee performs the fair value determinations for the fund on the board's behalf subject to appropriate oversight by the fund's board. Some commenters believed that the term "assign" could suggest that the board has completely delegated the entire valuation function and related obligations to the adviser.[140] We do not intend this result. Accordingly, the final rule uses the term "designate" instead of "assign."

Who May Be Designated

In a change from the proposal, which would have permitted boards to assign only to an adviser of the fund, the final rule will permit boards to designate the fund's adviser to perform fair value determinations or, if the fund is internally managed, an officer of the fund.[141] Many commenters recommended that we expand the types of entities that could perform fair value determinations on behalf of the board beyond the fund's adviser. Commenters suggested that we

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138 *See* ABA Comment Letter; MFDF Comment Letter; Stradley Comment Letter; Dechert Comment Letter (stating that "assign" applies to rights and interests, not responsibilities).

139 *See* ABA Comment Letter (noting that this term is used in rule 38a-1).

140 *See* Stradley Comment Letter (stating that "assign" seems broader than "delegate"); ABA Comment Letter.

141 Rule 2a-5(b).

permit any affiliate of the adviser;[142] fund administrators and affiliates;[143] committees composed of a blend of personnel or officers of the fund, adviser, or administrator;[144] pricing services;[145] accounting firms;[146] or any party the board has determined has sufficient expertise and capacity to conduct the fair value determinations.[147] Some also recommended that we permit officers of internally managed funds to conduct this activity because these funds do not have advisers.[148]

These commenters suggested that an expanded list of permissible entities would more accurately reflect current organizational structures and practices, would make it easier for smaller funds to comply with rule 2a-5, and would facilitate boards that would prefer non-advisers that may have fewer conflicts of interest.[149] Some commenters believed it was

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142 *See* Sullivan Comment Letter; ICI Comment Letter; Seward & Kissel Comment Letter; Comment Letter of Russell Investment Management, LLC (July 20, 2020) ("Russell Comment Letter"); Dechert Comment Letter.

143 *See* ICI Comment Letter; IDC Comment Letter; Seward & Kissel Comment Letter; Murphy Comment Letter (suggesting this would address "turnkey" fund situations where the adviser typically only provides investment advice but the administrator performs other functions such as valuation); John Hancock Comment Letter (suggesting affiliated administrators); Advisor's Inner Circle Trustees Comment Letter; Dechert Comment Letter; *see also* John Hancock Comment Letter (stating that if the administrator is an affiliate of the adviser, the board can exercise oversight through its relationship with the adviser and that staff guidance provides some further protections); Advisor's Inner Circle Trustees Comment Letter (recommending permitting reporting by non-advisers, such as fund administrators and pricing services).

144 *See* ICI Comment Letter; Seward & Kissel Comment Letter;

145 *See* CFA Institute Comment Letter; Dimensional Comment Letter. *But see* ICE Data Comment Letter (recommending that pricing services not be permitted to be assigned).

146 *See* CFA Institute Comment Letter. *But see* ICE Data Comment Letter (recommending that accounting firms not be permitted to be assigned).

147 *See* Murphy Comment Letter; VRC Comment Letter; Advisor's Inner Circle Trustees Comment Letter.

148 *See* Sullivan Comment Letter; Deloitte Comment Letter; Seward & Kissel Comment Letter; SBIA Comment Letter; NYC Bar Comment Letter; *see also* Dechert Comment Letter; Franklin Comment Letter (recommending permitting officers generally).

149 *See* ICI Comment Letter; IDC Comment Letter; Russell Comment Letter; Seward & Kissel Comment Letter (stating that advisers could raise their fees in response to the proposed rule, resulting in higher costs for funds if they can only assign to advisers).

unnecessary for the party performing fair value determinations to be a fiduciary of the fund.[150] In contrast, others suggested that a fiduciary relationship is important.[151]

We generally decline to expand permissible designees beyond the adviser in the final rule because we believe that it is critical for the entity actually performing the fair value determinations to owe a fiduciary duty to the fund and be subject to direct board oversight whenever possible.[152] While these other parties may not have the same conflicts as an adviser, they also generally have other conflicts that could influence their fair value determinations. For example, pricing services may have an interest in maintaining continuing business relationships with the adviser or fund, which could present conflicts[153] and in such cases, unlike advisers,[154] their performance of fair value determinations may not be subject to the same fiduciary obligations owed to the fund.[155] We believe that having fiduciary obligations to the fund will help ensure that the party performing fair value determinations acts in the fund's best interest and, as appropriate, eliminates, mitigates, or discloses conflicts.[156] Further, we believe that it is important for the valuation designee to have a direct relationship with the fund's board and have comprehensive and direct knowledge of the fund.[157] This is true of the fund's adviser, whose advisory contract is subject to substantive board oversight pursuant to the Act,[158] or, in the case

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150 *See* Seward & Kissel Comment Letter; Russell Comment Letter; *see also* Harvest Comment Letter (stating that fiduciary duties or registration status should not matter and that the board should only assign to third parties based upon experience, expertise, accuracy, and documentation and be fully vetted).

151 *See generally* IHS Market Comment Letter (recommending that we agree that pricing services are acting as fiduciaries when involved in the valuation process). We did not propose to require pricing services to act as fiduciaries as part of this rulemaking, and do not believe that it is appropriate to make such a mandate as part of this adoption.

152 *See, e.g.,* Proposing Release, *supra* footnote 2, at 106.

153 *See also supra* section II.A.4 (discussing these conflicts).

154 *See infra* footnote 219 and accompanying text.

155 *See also infra* footnotes 184–186 and accompanying text.

156 *See, e.g.,* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (Jun. 5, 2019) [84 FR 33669 (July 12, 2019)] ("Commission Fiduciary Interpretation").

157 *See, e.g., supra* sections II.A.1 and II.A.2.

158 *See* section 15(c) of the Act.

of internally-managed funds, officers of the fund. To the extent that other parties provide services that are essential for fair value determinations, the board or valuation designee can seek their assistance as discussed below.

We recognize, as commenters stated, that internally managed funds have no adviser. Instead they rely on certain officers of the fund to perform the broad range of tasks that advisers to externally managed funds otherwise perform.[159] These officers also have fiduciary duties,[160] and as employees of the fund are subject to oversight by the fund's board of directors. We believe that internally managed funds should not be excluded from this provision of the final rule solely because they have no adviser. Thus, in a change from the proposal, the final rule also permits such a fund's board to designate an officer or officers of the fund to perform the fair value determinations if the fund does not have an adviser.[161]

In the Proposing Release, we stated that the proposed rule would permit boards to assign either to the fund's primary adviser or one or more sub-advisers.[162] While some commenters generally supported the flexibility this interpretation would afford,[163] others opposed or had concerns about it, arguing that sub-advisers do not currently perform this task and permitting them to do so could significantly increase costs.[164] Some did not object to the flexibility but stated that having sub-advisers involved in valuation was inconsistent with some current

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159 To the extent that the officers tasked with performing these duties have additional conflicts, such as by being compensated with fund shares, boards should consider those conflicts and any other conflicts prior to permitting this delegation. *See infra* section II.B.1.

160 *See, e.g., Zirn v. VLI Corp.*, 621 A.2d 773 (Del. 1993); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503, 510 (1939). *See also* SBIA Comment Letter (arguing that officers of internally managed funds should be permitted to perform fair value determinations because officers of such funds generally have fiduciary and similar duties to the fund and its equity holders).

161 Rule 2a-5(e)(4). Because these officers are "valuation designees" under the final rule, they will be required to perform all the functions rule 2a-5 will require of valuation designees, including the mandatory board reporting.

162 Proposing Release, *supra* footnote 2, at 33-34.

163 *See, e.g.,* TRP Comment Letter; IAA Comment Letter; CFA Institute Comment Letter; Vanguard Comment Letter.

164 *See* MFS Comment Letter; Seward & Kissel Comment Letter.

practices, with some questioning if this would be an appropriate role for a sub-adviser.[165] A number of commenters raised concerns about how permitting assignment to sub-advisers would work in practice, for example, how to resolve conflicting fair value determinations,[166] and requested that we provide guidance on how to reconcile in such circumstances.[167]

The final rule will not permit boards to designate the performance of fair value determinations to fund sub-advisers.[168] However, consistent with the guidance below, boards or their valuation designee can seek the assistance of sub-advisers as they see appropriate. We proposed allowing designation to sub-advisers as a method to provide additional flexibility to boards. After considering the increased complexity identified by commenters that this flexibility may create, and commenters' assertions that sub-advisers typically do not currently serve in this role,[169] we have determined that any benefits provided by this additional flexibility would not be justified by the additional challenges it may create. We also are concerned that allowing designation to sub-advisers may create complicated reconciliation and oversight issues for boards, advisers, and sub-advisers. However, we welcome engagement with respect to the role of sub-advisers in the fair value determination process.

The proposed rule would have permitted only the UIT's trustees to perform fair value determinations.[170] Commenters stated that the final rule should permit the parties specified as evaluators in the UIT's trust indenture or similar document, including the depositor and other entities, to perform fair value determinations under rule 2a-5. These commenters argued that these evaluators are the entities with relevant expertise in valuation matters and this change

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165 *See* Capital Group Comment Letter; IAA Comment Letter; SIFMA AMG Comment Letter; *see also* TRP Comment Letter (noting it could increase costs to assign to a sub-adviser).

166 *See* Seward & Kissel Comment Letter; SIFMA AMG Comment Letter.

167 *See* Capital Group Comment Letter; CFA Institute Comment Letter; MFS Comment Letter; IAA Comment Letter; *see also* SIFMA AMG Comment Letter.

168 Rule 2a-5(e)(4) (defining "valuation designee" as, among other things, an adviser other than a sub-adviser).

169 *See* MFS Comment Letter; Seward & Kissel Comment Letter.

170 Proposed rule 2a-5(d).

would make rule 2a-5 more consistent with current practice.[171] Others asked that we not apply the final rule's requirements to existing UITs given their trust indentures are currently drafted to permit entities other than trustees to value the UITs' investments.[172] One commenter stated that the cost to implement the proposed rule could be significant for UITs due to the change in practice.[173]

In other contexts under the Investment Company Act, the Commission has provided for a UIT's depositor to conduct activities that the board of directors would otherwise conduct, given that a UIT has neither a board of directors nor an adviser.[174] UIT depositors are subject to liability under section 36(a) of the Act for breach of fiduciary duty.[175] We agree, in light of these comments, that UITs should not be limited to trustees to perform their fair value determinations. As we understand that the trustee traditionally has not performed fair value determinations, and we have recognized in the past that depositors generally serve the most equivalent function to an adviser for UITs,[176] the final rule will permit either the fund's depositor or trustee to perform the fair value determinations required under rule 2a-5.[177] To the extent that the assistance of other

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171 *See* ICI Comment Letter; Comment Letter of Chapman and Cutler LLP (July 20, 2020) ("Chapman Comment Letter"); Comment Letter of Advisers Asset Management, Inc. (July 20, 2020) ("AAM Comment Letter"); Comment Letter of First Trust Portfolios L.P. (July 21, 2020) ("First Trust Comment Letter"); Comment Letter of Hennion & Walsh, Inc. (July 20, 2020) ("Hennion & Walsh Comment Letter"); Invesco Comment Letter; Comment Letter of the Bank of New York Mellon (July 20, 2020) ("BNY Mellon Comment Letter"); *see also* Seward & Kissel Comment Letter (suggesting permitting UIT trustees to assign to any assignee).

172 *See* Chapman Comment Letter; AAM Comment Letter; First Trust Comment Letter.

173 *See* BNY Mellon Comment Letter. Some commenters also asked that we clarify that the oversight elements of paragraph (b) do not apply to UITs. *See* Chapman Comment Letter; AAM Comment Letter; First Trust Comment Letter; Hennion & Walsh Comment Letter; BNY Mellon Comment Letter. Because paragraph (b) only applies when a board designates the performance of fair value determinations to a valuation designee, which a UIT will not have, we agree that it is inapplicable to UITs.

174 *See, e.g.,* 17 CFR 270.17j-1(c)(1)(iii) ("rule 17j-1") and 38a-1(b).

175 *See* section 36 of the Act; *see also* Memorandum on the Regulation of Unit Investment Trusts from the Division of Investment Management to the Securities and Exchange Commission, Fed. Sec. L. Rep. (CCH) 84,328 (Sep. 22, 1988).

176 *See, e.g.,* items 25 through 31 of Form N-8B-2 (requiring information regarding depositors that is similar to that required of an adviser to a management company in item 10 of Form N-1A).

177 Rule 2a-5(d).

parties (such as evaluators) is necessary, trustees or depositors can seek that assistance consistent with the guidance below regarding obtaining the assistance of others.

In recognition of commenters' statements that there would be significant costs for pre-existing UITs to change who engages in the fair value determination as they might need to amend their trust indenture (and potentially obtain a unit holder vote approving the change) we are grandfathering existing UITs under limited circumstances. Thus, the final rule will now require trustees or depositors to perform fair value determinations if the UIT's date of initial deposit (which would include a rollover) of portfolio securities occurred after the effective date of rule 2a-5. If the initial deposit of securities into the UIT took place *prior* to the effective date of the final rule, to the extent that an entity other than the UIT's trustee or depositor has been designated in the trust indenture to perform fair value determinations, that previously designated entity may perform such fair value determinations pursuant to paragraph (a) of the final rule.[178] We believe that this approach should be acceptable, even though the party making fair value determinations under this provision may not be subject to the same fiduciary duties, as this outcome reflects a balancing of the costs and risks, informed by the unmanaged and fixed nature of these UITs, and because of the limited nature of this relief.[179] Further, we believe that the number of these funds that will be able to utilize an entity other than a depositor or trustee will be small and decrease over time.[180] We are also concerned that it would be unlikely that pre-existing UITs could comply with the final rule absent this provision given the statutory

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178 To be clear, this exception from the requirement to utilize a depositor or trustee for fair value determinations will not continue to be available when a pre-existing UIT is rolled over to a new UIT after the termination date of the pre-existing UIT. In such a case, when the rollover occurs, the new UIT will be required to designate either the depositor or trustee to perform fair value determinations consistent with the final rule. In addition, if a pre-existing UIT has a trustee or depositor already designated to perform the fair value determination, then that entity would be the entity responsible for performing the fair value determination requirements under the final rule.

179 *See generally* Fund of Funds Arrangements, Investment Company Release No. 34045 (Oct. 17, 2020) [85 FR 73924 (Nov. 19, 2020)] ("FOF Adopting Release") at 92.

180 We believe that the universe of UITs relying on this exception will be small. *See infra* footnote 550 and accompanying text. Further, as we have noted previously, many existing UITs have a limited term, sometimes of approximately 12 to 18 months. FOF Adopting Release, *supra* footnote 179, at n.332 and accompanying text.

requirement that UITs be organized under a trust indenture, contract of custodianship or agency, or similar instrument (the terms of which, in these limited cases, provide for an evaluator other than the trustee or depositor). Further, we believe that this approach should address commenter concerns about disrupting existing UIT fair value determination designees and the associated potential costly changes which could affect investors if the costs are passed on to them.

As proposed, the final rule defines "board" both as the full board or a designated committee thereof composed of a majority of directors who are not interested persons of the fund.[181] We received limited comments on this aspect of the proposal. One commenter, however, suggested that the fund should be required to develop policies and procedures for when the whole board, rather than a committee, would be required to be involved.[182] Conversely, another stated that because state law permits fund boards to empower specific committees to act on behalf of the entire board, rule 2a-5 was sufficient as proposed.[183] We believe that no such changes are necessary to this provision because it is important that boards be able to utilize specialized committees, particularly on matters as detailed and important as valuation. Should a fund choose to develop policies and procedures regarding when a matter is more appropriate for the full board, it can do so, but it will not be required under the final rule.

One commenter wanted clarification that the fund's adviser could perform fair value determinations on the board's behalf regardless of whether it is acting pursuant to an advisory contract, administrative contract, or similar agreement.[184] Another asked that we clarify when a pricing service that is a Commission-registered adviser would be considered an "investment adviser" for purposes of the final rule.[185] The final rule, consistent with the proposal, provides

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181 Rule 2a-5(e)(3).

182 *See* IVSC Comment Letter.

183 *See* Murphy Comment Letter.

184 *See* John Hancock Comment Letter.

185 *See* ICE Data Comment Letter.

that where the valuation designee is an adviser, it must be an "adviser of the fund." This would not include other service providers, whether or not they are registered as advisers, or acting under a contract with the fund, unless they are actually serving as the adviser of the fund as defined under the Investment Company Act because they may not have a comprehensive and direct knowledge of the fund, a direct relationship with the board, or the same fiduciary duties to the fund in other cases.[186] As discussed above, it also would not include a sub-adviser to the fund.

Guidance on Obtaining the Assistance of Others

Some commenters also asked that we clarify that the adviser or the fund board could engage third parties to assist with certain functions of the fair value determination process, such as performing back-testing, fund accounting, or shareholder reporting, other than making the actual determinations themselves.[187] Others urged us to state that advisers assigned to perform fair value determinations under the proposed rule could, in turn, assign their responsibilities to other third parties.[188]

We believe that whether the board or the valuation designee makes fair value determinations under the final rule, it may of course obtain assistance from others in fulfilling its duties. It may, for example, seek assistance from pricing services, fund administrators, sub-advisers, accountants, or counsel.[189] That assistance can take different forms, and may include services such as performing back-testing as specified by the valuation designee and performing calculations required by the valuation method selected by the board or valuation designee. The

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186 *See* section 2(a)(20) (defining investment adviser of an investment company). *See also supra* footnotes 152 - 156 and accompanying text (explaining why we are generally not permitting parties other than the adviser to be valuation designees under the final rule).

187 *See* Sullivan Comment Letter; Fidelity Comment Letter; NYC Bar Comment Letter (asserting fund boards must be able to rely upon fund auditors and counsel); Dechert Comment Letter.

188 *See* Russell Comment Letter.

189 For example, some commenters suggested that the administrator may be better positioned to perform the fair value determinations under rule 2a-5 than an adviser. *See* Sullivan Comment Letter. For the reasons discussed above, we determined generally to limit the valuation designee to the fund's adviser. *See supra* footnotes 152 - 158 and accompanying text.

board or the valuation designee, using this assistance, must of course also perform its responsibilities under the Act, the final rule, and other applicable rules under the Act. However, in seeking the assistance of others, the entity or officer designated to perform the fair value determination remains responsible for that determination and may not designate or assign that responsibility to the third party for the same reasons we are not permitting the board to designate performance of this task to a party other than the valuation designee.[190]

1. Board Oversight

The final rule, consistent with the proposal, specifically requires a board to oversee the valuation designee if the board has designated the performance of fair value determinations to the valuation designee.[191] In the proposal, we provided guidance on our expectations related to this board oversight.[192] A number of commenters supported this guidance,[193] with one commenter stating that the discussion properly reflects the general roles of boards and advisers under both current practices of properly functioning boards as well as Federal and state law.[194] However, other commenters questioned parts of the guidance or asked that we provide further guidance on certain issues.

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190 *See supra* footnotes 152 - 158 and accompanying text.

191 Rule 2a-5(b).

192 Proposing Release, *supra* footnote 2, at nn.84-94 and accompanying text.

193 *See* Council of Institutional Investors Comment Letter; Fidelity Comment Letter; VRC Comment Letter; Invesco Comment Letter; CFA Institute Comment Letter; Comment Letter of Better Markets (July 21, 2020) ("Better Markets Comment Letter"); *see also* IDC Comment Letter (agreeing with the lack of specificity of "oversight" in the proposed rule). One of these commenters recommended that we require that boards have the requisite experience, knowledge, and sufficient lack of conflicts to fulfill their obligations. Better Markets Comment Letter. Another suggested that directors be required to have "valuation literacy." CFA Institute Comment Letter. The commenter did not clarify what is meant by "valuation literacy" and we do not believe that an affirmative requirement is necessary. However, the board's statutory obligation for determining fair value in good faith, as well its oversight obligation with respect to any valuation designee under new rule 2a-5, generally warrants consideration of the appropriateness of director qualifications, such as with respect to accounting and valuation matters, when funds and boards are identifying potential board candidates. The Commission understands that board members are often selected to provide a variety of specialized knowledge and experience, including in accounting and valuation.

194 *See* Fidelity Comment Letter; *see also* ICI Comment Letter (stating that the proposal correctly distinguished oversight from design and administration).

Some of these commenters argued that board oversight of the valuation process should be the same as the oversight of other functions, such as liquidity risk.[195] While we agree that boards should provide oversight in those contexts as well, we believe that we should provide specific guidance with respect to board oversight in the context of making fair value determinations. We believe that specific guidance is appropriate because section 2(a)(41) is one of the few provisions of the Act that specifically imposes a requirement on fund boards, requiring boards to determine fair value in good faith. Therefore, this guidance supports our view that a board may still satisfy its statutory obligation to determine fair value even though it has designated another entity to perform the fair value determinations under the final rule, subject to appropriate oversight.[196]

A number of commenters questioned the guidance stating that boards must be active in their oversight role by probing reports written by advisers and being inquisitive,[197] but other commenters agreed that board oversight cannot be a passive activity.[198] We believe that boards are not providing appropriate oversight if they simply rely on information presented to them without actively probing it, asking questions, and seeking relevant information, particularly when there are red flags or other indications of problems. Some commenters asked us to state that the board does not have an independent duty to seek to discover conflicts of interest but can reasonably rely upon the adviser's identification of these conflicts,[199] but one stated we should

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195 *See* MFDF Comment Letter; ABA Comment Letter (requesting the Commission to reiterate, as it had in the adopting release for 17 CFR 270.22e-4 ("rule 22e-4"), that the board role under this rule is substantially similar to its roles and responsibilities in other contexts under the Act and that providing a different standard of care for board action would not be appropriate); Advisor's Inner Circle Trustees Comment Letter; *see also* NYC Bar Comment Letter.

196 *See* section 1(b) of the Act ("it is hereby declared that the national public interest and the interest of investors are adversely affected... when investment companies, in computing their earnings and the asset value of their outstanding securities... are not subjected to adequate independent scrutiny").

197 *See* IDC Comment Letter; ABA Comment Letter; Stradley Comment Letter; Capital Group Comment Letter; Advisor's Inner Circle Trustees Comment Letter; *see also* NYC Bar Comment Letter (stating that oversight should consist of reviewing reports and determining corrective action); Dechert Comment Letter; American Funds Trustees Comment Letter. *Cf.* Proposing Release, *supra* footnote 2, at nn.89-94 and accompanying text.

198 *See* Fidelity Comment Letter; Invesco Comment Letter; CFA Institute Comment Letter; Better Markets Comment Letter.

199 *See* Sullivan Comment Letter; ABA Comment Letter.

clarify that the board has an affirmative duty to do so.[200] Another stated that the board should be able to rely upon the adviser much the same way that it can reasonably rely upon others, such as fund CCOs, administrators, and counsel.[201] As discussed below in the guidance on board oversight, we are reiterating our belief, stated in the Proposing Release, that boards should seek to identify potential conflicts of interest as part of their oversight duties under the final rule. Boards must work with valuation designees, which also have a duty to disclose their conflicts,[202] to address or manage these conflicts to the board's satisfaction.

Although several commenters asked us to confirm that boards may provide oversight of the performance of fair value determinations consistent solely with the business judgment rule under state law, we decline to do so.[203] Instead, we are providing guidance that we believe should be more useful to directors than the more generalized principles of the business judgment rule, as this new guidance specifically relates to directors' oversight responsibilities under section 2(a)(41) of the Act and the final rule.

Finally, several commenters recommended that we adopt additional oversight requirements, such as third-party reviews, attestations, or certifications by the adviser,[204] or that we require the board to make specific findings.[205] Others argued that additional requirements were unnecessary due to state law duties applicable to boards or because the expense was not justified by the regulatory benefits.[206] Several commenters also asked that we clarify whether

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200 *See* CFA Institute Comment Letter.

201 *See* IDC Comment Letter; Stradley Comment Letter.

202 *See, e.g.,* Commission Fiduciary Interpretation, *supra* footnote 156, at n.24.

203 *See* ABA Comment Letter; Stradley Comment Letter.

204 *See* IVSC Comment Letter; CFA Institute Comment Letter; *see also* ABA Comment Letter (recommending a certification by the adviser similar to that required in rule 17j-1); Council of Institutional Investors Comment Letter (supporting an attestation requirement).

205 *See* ICE Data Comment Letter; Murphy Comment Letter.

206 *See* Murphy Comment Letter; Comment Letter of Timothy Keehan, Vice President & Senior Counsel, American Bankers Association ("American Bankers Association Comment Letter").

directors are expected to ratify fair value determinations made by the adviser under rule 2a-5.[207] We are not adding specific oversight requirements in the final rule beyond those that were proposed. We believe that the oversight requirements of boards under the final rule, discussed below, taken together with the directors' fiduciary duties, are reasonably designed to establish a minimum set of requirements for addressing the conflict of interest and other concerns associated with permitting a valuation designee to make fair value determinations. As such, we believe that additional requirements like those suggested by these commenters may be duplicative or involve burdens that are not justified by their potential benefits. The final rule does not require boards to ratify fair value determinations made by the valuation designee, as we believe it is not a necessary component of active oversight.

Guidance on Board Oversight

We reiterate the guidance on board oversight of the fair value determination process from the Proposing Release.[208] When the board designates the performance of fair value determinations to the valuation designee, the final rule will require the board to satisfy its statutory obligation with respect to these determinations through the framework of rule 2a-5, including overseeing the valuation designee. Boards should approach their oversight of the performance of fair value determinations by the valuation designee 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 appropriateness of the fair value determination process, and the skill and resources devoted to it.[209] Further, in our view appropriate oversight cannot be a passive activity. Directors should ask questions and seek relevant information.

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207 *See* ABA Comment Letter.

208 Proposing Release, *supra* footnote 2, at nn.84-94 and accompanying text.

209 *See generally* Investment Company Governance, Investment Company Act Release No. 26520 (July 27, 2004) [69 FR 46378 (Aug. 2, 2004)] ("Governance Release").

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.[210] The final rule will require the valuation designee to report to the board with respect to matters related to the valuation designee's fair value process, in part to ensure that the board has sufficient information to conduct this oversight.[211] Boards should also request follow-up information when appropriate and take reasonable steps to see that matters identified are addressed.[212]

We 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.[213]

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 reasonable steps to manage such conflicts.[214] In so doing, the board should serve as a meaningful check on the conflicts of interest of the valuation designee and other service providers involved

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210 *Cf.* Derivatives Adopting Release, *supra* footnote 6 (noting that "the use of the word 'iterative' is not intended to imply that the board is responsible for the day-to-day management of the fund's derivatives risk, but is instead intended to clarify that the board's oversight role requires regular engagement with the derivatives risk management program rather than a one-time assessment").

211 Rule 2a-5(b)(1).

212 *See also* Governance Release, *supra* footnote 209 (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").

213 For a discussion of valuation risks generally, *see supra* section II.A.1.

214 *See, e.g.,* Governance Release, *supra* footnote 209 ("...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.").

in the determination of fair values.[215] In particular, the fund's adviser may have an incentive to value fund assets improperly in order to increase fees, improve or smooth reported returns, or comply with the fund's investment policies and restrictions.[216] 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 valuation designee)[217] or may otherwise be subject to pressures to provide pricing estimates that are favorable to the valuation designee.[218] In overseeing the valuation designee'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 valuation designee as part of the process, and satisfy itself that any conflicts are being appropriately managed.

Boards should probe the appropriateness of the valuation designee's fair value processes. In particular, boards should periodically review the financial resources, technology, staff, and expertise of the valuation designee, and the reasonableness of the valuation designee's reliance on other fund service providers, relating to valuation.[219] In addition, boards should consider the

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215 *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").

216 *See, e.g.,* In re Piper Capital Management, et al., Investment Company Act Release No. 26167 (Aug. 26, 2003) (Commission opinion). For discussion of the conflicts of the fund's portfolio manager, see *infra* section II.B.3. Further, officers of internally managed funds may have other conflicts that boards should consider. *See supra* footnote 159.

217 *See supra* footnote 97 and accompanying text.

218 *Cf.* In re Morgan Asset Management, Investment Company Act Release No. 29704 (June 22, 2011) (settlement) ("In re Morgan Asset Management") 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"). *See also supra* footnote 154 and accompanying text.

219 *See* In re Morgan Asset Management, *supra* footnote 218 ("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").

valuation designee's compliance capabilities that support the fund's fair value processes, and the oversight and financial resources available for the fair value process.

Boards should also consider the type, content, and frequency of the reports they receive. The final rule will require reporting to the board (both periodically and promptly) regarding many aspects of the valuation designee'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 valuation designee and other service providers in conducting appropriate oversight, it is incumbent on the board to request and review such information as may be necessary to be informed of the valuation designee's process for determining the fair value of fund investments.[220] Further, if the board becomes aware of material matters (whether the board identifies the matter itself or the fund's CCO, valuation designee, 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.

2. Board Reporting

As modified in response to comments received, the final rule will require a valuation designee that the board has designated to perform fair value determinations to report to the board regarding its performance of that responsibility, including certain periodic reports and prompt notification and reporting on matters that materially affect the fair value of investments whose fair value is determined by the valuation designee.[221] These requirements are intended to assist boards in their oversight responsibility under the final rule and to help ensure that boards receive

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220 In the Proposing Release, we had characterized the board's role as requiring that it be "fully informed" of the adviser's process. Two commenters questioned what that means in this context. *See* Deloitte Comment Letter and ABA Comment Letter. Our intent was to make sure that the board was not solely relying upon the information provided to it by the valuation designee, but was thoughtful and sought additional information when needed. However, we did not intend to imply that the board should be actively managing the process. We have therefore deleted the word "fully" in this release to avoid that implication.

221 Rule 2a-5(b)(1).

the amount and type of information to oversee the valuation designee appropriately by familiarizing directors with the salient features of, and developments in, the valuation designee's process.[222] These are minimum requirements and boards may find, depending on the facts and circumstances, that additional information is necessary or appropriate in order to discharge their oversight responsibilities appropriately.

a) Periodic Reporting

The final rule will require the valuation designee to make both annual and quarterly written reports to the board.[223] Specifically:

- *Quarterly Reports.* The valuation designee must provide at least quarterly, in writing, (1) any reports or materials requested by the board related to the fair value of designated investments or the valuation designee's process for fair valuing fund investments and (2) a summary or description of material fair value matters that occurred in the prior quarter. This summary or description must include (1) any material changes in the assessment and management of valuation risks, including any material changes in conflicts of interest of the valuation designee (and any other service provider), (2) any material changes to, or material deviations from, the fair value methodologies,[224] and (3) any material changes to the valuation designee's process for selecting and overseeing pricing services, as well as any material events related to the valuation designee's oversight of pricing services.[225]
- *Annual Reports.* The valuation designee must provide at least annually, in writing, an assessment of the adequacy and effectiveness of the valuation designee's

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222 *See also* Proposing Release, *supra* footnote 2, at 41-42.

223 Rule 2a-5(b)(1)(i).

224 Valuation designees can utilize this report to notify the board of changes to methodologies that are equally or more representative of fair value of the investments. *See supra* section II.A.2.a.

225 Rule 2a-5(b)(1)(i)(A).

process for determining the fair value of the designated portfolio of investments. At a minimum, this annual report must include a summary of the results of the testing of fair value methodologies required under the final rule and an assessment of the adequacy of resources allocated to the process for determining the fair value of designated investments, including any material changes to the roles or functions of the persons responsible for determining fair value.[226]

After considering comments, we have made certain changes to the proposed periodic reporting requirements designed to enhance flexibility of reporting to better match boards' needs and to minimize the chance that boards receive reporting that is too detailed or repetitive to facilitate appropriate oversight. The proposed rule would have required quarterly reporting on a variety of valuation matters.[227] Commenters raised concerns regarding these proposed reporting requirements. Some stated that, while some reporting is necessary, the proposed reporting requirements were overly prescriptive and would not result in appropriate board oversight in practice.[228] Commenters also generally believed that we should give greater deference to boards to use their business judgment to request the information and the frequency of reports that they see as necessary.[229] Some of these commenters supported a program where the adviser would make quarterly reports on material changes to aspects of, or deviations from, the program, with a

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226 Rule 2a-5(b)(1)(i)(B).

227 Proposed rule 2a-5(b)(1)(i).

228 *See, e.g.,* ICI Comment Letter; SSGA Comment Letter; TRP Comment Letter; Guggenheim Comment Letter; Vanguard Comment Letter. *See also* JPMAM Comment Letter.

229 *See, e.g.,* Fidelity Trustees Comment Letter; BlackRock Trustees Comment Letter; Murphy Comment Letter; Fidelity Comment Letter (asserting the proposed reporting mechanism would lead to reporting designed to fulfill a regulatory requirement rather than assist with board oversight).

broader annual report covering the overall design and implementation of the program.[230] Others recommended that we permit the board to set reporting standards.[231]

The proposed rule would have included a number of specific items to be included in the quarterly assessment to boards. Specifically, the proposed rule would have required the quarterly report to include: (1) a summary or description of the assessment and management of material valuation risks (including material conflicts of interest), (2) material changes to, or material deviations from, established fair value methodologies, (3) testing results, (4) adequacy of resources allocated to fair value determinations, (5) material changes to the adviser's process for selecting and overseeing pricing services (including changes in service providers and price overrides), as well as (6) any other materials requested by the board. A number of commenters objected to many of these specific items being reported on a quarterly basis, asserting that the cost to produce them on a quarterly basis would exceed the costs the Commission assumed[232] and the requirements could result in over-reporting to satisfy regulatory obligations or liability concerns rather than to facilitate oversight.[233] Commenters also asserted that many of the reporting items, and particularly valuation risks and adequacy of resources, would not change

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230 *See, e.g.,* Sullivan Comment Letter; JPMAM Comment Letter; ICI Comment Letter; IDC Comment Letter; ABA Comment Letter; Murphy Comment Letter. *See also* Federated Hermes Comment Letter; Baillie Gifford Comment Letter (recommending that, to the extent that quarterly reporting is retained, it be permitted to focus on material changes or exceptions and allow summary dashboards). *See also generally* BlackRock Trustees Comment Letter (detailing their current reporting mechanism of annual reports on the overall framework, quarterly valuation reports with the information the board wants, and monthly reports concerning NAV accuracy and pricing errors).

231 *See, e.g.,* BlackRock Trustees Comment Letter; MFDF Comment Letter; SSGA Comment Letter; Fidelity Comment Letter; Dechert Comment Letter; Advisor's Inner Circle Trustees Comment Letter; *see also* American Funds Trustees Comment Letter (stating that they rely upon the oversight of the compliance process under rule 38a-1 to perform oversight); SIFMA AMG Comment Letter (urging flexible reporting depending upon the type of inputs).

232 *See* Sullivan Comment Letter; TRP Comment Letter; SIFMA AMG Comment Letter; American Trustees Comment Letter.

233 *See* TRP Comment Letter; Fidelity Comment Letter; Dechert Comment Letter; SIFMA AMG Comment Letter; *see also* Capital Group Comment Letter.

frequently enough to justify quarterly reporting.[234] Many of these commenters suggested that we instead require advisers to report some or all of these items on an annual basis,[235] or remove some of them altogether, particularly reporting on specific price overrides, to provide more relevant information and to reduce burdens on boards.[236]

We agree that boards should have latitude to implement a flexible reporting mechanism that is tailored to their fund, recognizes judgment in exercising oversight, and minimizes rote reporting. That said, we believe that appropriate oversight, facilitated by a certain minimum level of reporting, is necessary in order for the designation process to be consistent with the Act.[237] As a result, we are making tailored changes to the proposed periodic reporting regime in the final rule designed to enable boards to receive the information they want and need to conduct appropriate oversight. We believe that the changes we are adopting today will allow reporting to address the specific circumstances of each fund, and reporting should be tailored to address the fund's holdings, valuation methodologies, and inputs, as urged by some commenters.[238]

Specifically, we have made adjustments to the overall proposed periodic reporting requirements. The final rule will require that the valuation designee report its assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of

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234 *See, e.g.,* Fidelity Trustees Comment Letter; JPMAM Comment Letter; IDC Comment Letter; BlackRock Trustees Comment Letter; Murphy Comment Letter; TRP Comment Letter; Guggenheim Comment Letter; SIFMA AMG Comment Letter; NYSSCPA Comment Letter; *see also* ICI Comment Letter (recommending removing adequacy of resources reporting); Baillie Gifford Comment Letter (recommending removing adequacy of resources reporting). *But see* ABA Comment Letter (recommending that we further require a narrative description of testing results); VRC Comment Letter (suggesting requiring the reporting of specific information on each individual portfolio holding for securities with a higher perceived risk profile).

235 *See, e.g.,* Sullivan Comment Letter; JPMAM Comment Letter; ICI Comment Letter; ABA Comment Letter; TRP Comment Letter. *See also* Federated Hermes Comment Letter; Advisor's Inner Circle Trustees Comment Letter; IHS Market Comment Letter (stating that it had observed best practices for reporting on pricing services to be board or committee approval of the provider itself and at least annual review of performance based upon back testing).

236 *See, e.g.,* Sullivan Comment Letter; Fidelity Trustees Comment Letter; Murphy Comment Letter; Fidelity Comment Letter; *see also* IAA Comment Letter (stating that significant increases in price challenges or overrides should not be considered a material valuation risk due to their routine nature); American Fund Trustee Comment Letter.

237 *See* section 1(b)(5) of the Act and *supra* footnote 196 and accompanying text discussing the need for independent oversight of the valuation process.

238 *See, e.g.,* SIFMA AMG Comment Letter.

designated investments, testing results, and adequacy of allocated resources at least annually rather than quarterly as proposed. In lieu of quarterly assessments of the entire fair value process, the final rule will instead require quarterly reports to address issues about which the board requests information, as well as information about material changes or events that occurred during the period.[239] These revisions are consistent with the suggestions from commenters noted above that we require annual overall reporting with quarterly updates regarding material changes. We believe that the changes in the final rule establish the necessary minimum reporting needed for appropriate oversight. Further, by expressly recognizing boards' authority to require any additional reports they want on a quarterly basis, the final rule seeks to empower boards to tailor periodic reporting to suit the needs of their fund, as recommended by commenters.

We have also made adjustments, in response to comments, from the proposal regarding the specific items that will be required to be part of periodic reports. In lieu of a discussion of the assessment and management of material valuation risks as part of the valuation designee's assessment, the final rule will instead require that the quarterly report identify material changes, including the identification of any material changes in the assessment or management of these risks that occurred during the quarter. We agree with commenters that this reporting could become rote if it does not change and have focused it upon material changes as a result.[240]

Some commenters suggested that the proposed rule, as worded, would have required the adviser to report every test result, service provider change, or price override to the board, which we did not intend.[241] We agree that these items may have provided a level of detail that may not

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239 Material fair value matters that occurred in the prior quarter related to the items reported on annually, such as significant changes to testing results or material reductions in the resources provided for the determination process, would, however, still be reported as part of the quarterly material change report.

240 However, boards may wish to consider periodically requesting a report assessing all material valuation risks (not just changes) faced by the fund, so that they remain apprised of the fund's overall valuation risk landscape.

241 *See, e.g.,* Sullivan Comment Letter; Fidelity Trustees Comment Letter; Murphy Comment Letter; Fidelity Comment Letter; *see also* IAA Comment Letter (stating that significant increases in price challenges or overrides should not be considered a material valuation risk due to their routine nature); American Fund Trustee Comment Letter.

be necessary. Therefore, we clarified that the annual assessment can contain a summary of testing results and removed a requirement to report service provider changes or price overrides. Lastly, we agree with commenters that the reporting of the summary of testing results and assessment of the adequacy of allocated resources is not needed quarterly because they are unlikely to change on a quarterly basis. Consistent with the overall change to an annual assessment, the final rule will require these results to be reported annually. However, based upon the summaries that they receive, boards can seek more information from the valuation designee if necessary to conduct appropriate oversight.[242]

Some commenters requested more clarification as to what constitutes "material" in the context of the final rule's reporting requirements,[243] suggesting that we create a "material valuation matter" standard that would be reported similar to serious compliance matters under the compliance rule,[244] that we permit the board to define materiality,[245] or use different terminology altogether to avoid confusion with accounting or auditing standards.[246] We believe that material matters in this context would generally be those matters about which the board would reasonably need to know in order to exercise appropriate oversight of the valuation designee's fair value determination process.[247] For example, material matters include significant deficiencies or material weaknesses in internal control over financial reporting related to fair value determinations that have been identified and generally would include those items that

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242 *See supra* section II.B.1. *See also* rule 2a-5(b)(1)(i)(A)(*1*).

243 *See* ABA Comment Letter; MFDF Comment Letter; SIFMA AMG Comment Letter (stating that the industry will likely look to the serious compliance issues standard from rule 38a-1 for guidance); AIMA Comment Letter (with regard to prompt reporting); Deloitte Comment Letter; *see also* University of Miami Comment Letter (suggesting that differences in what constitutes materiality could lead to delays in prompt reporting); MFS Comment Letter (the prompt reporting requirement is unnecessary because of the similarity of materiality in this rule with serious compliance matters under rule 38a-1).

244 *See* Stradley Comment Letter; Dechert Comment Letter.

245 *See* Vanguard Comment Letter.

246 *See* Duff & Phelps Comment Letter.

247 This standard is similar to that of "material compliance matter" found in rule 38a-1. *See* rule 38a-1(e)(2).

"could have materially affected" the fair value of the fund's investments as proposed.[248] We believe that material matters also include other issues, such as a change to a pricing service affiliated with the valuation designee or material changes to or deviations from methodologies, including changes to critical inputs or assumptions.[249] As another example, with regards to material changes to the selection or oversight of pricing services, a pattern of price challenges or overrides over time that raise concerns with the overall valuation process may be material. The valuation designee should identify material issues, and the board should follow-up as necessary for its oversight.

The final rule will require the valuation designee's reports to include such information as may be reasonably necessary for the board to evaluate the matters covered in the reports.[250] Based upon that information, the board can determine whether to ask additional questions or request additional information, as appropriate. For example, if a valuation designee reports that there is a new material conflict of interest, the valuation designee should provide, and the board should seek,[251] additional information as necessary for the board to evaluate the potential impact of the conflict on the adequacy and effectiveness of the valuation designee's determinations of fair value. As another example, where a valuation designee has materially changed a fair value methodology, the report could summarize the relevant market conditions or other circumstances

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248 To align the material matters that would be reported with Commission rules and auditing standards better, we are eliminating the term "could have materially affected" from the final rule and instead are using the term material matter alone. Material matters under the final rule would generally include, for example, material weaknesses and significant deficiencies as defined in 17 CFR 210.1-02(a)(4) that are related to fair value determinations. Some commenters questioned the relevance of financial reporting concepts when reporting regarding fair value determinations. *See* ABA Comment Letter; TRP Comment Letter (regarding prompt, but not periodic, reporting). We believe that these issues can be significant as the lack of sufficient controls over financial reporting could have significant implications in the fund's fair value determinations. *See also* TRP Comment Letter (supporting a system of annual reporting for many items but quarterly reporting for significant deficiencies and material weaknesses in internal controls over financial reporting in lieu of prompt reporting on these items).

249 *See* Proposing Release, *supra* footnote 2, at n.104 and accompanying text.

250 Rule 2a-5(b)(1).

251 *See supra* section II.B.1 ("Further, in our view effective oversight cannot be a passive activity. Directors should ask questions and seek relevant information.").

leading to the decision to apply an alternate methodology and the alternate fair value methodology used.

Some commenters were concerned that this requirement will result in advisers providing extraneous or out-of-context information, such as back-testing results, to the board.[252] The specific content of the periodic or prompt reports and supplemental information under the final rule is left to the board and valuation designees. These reports can take the form of narrative summaries, graphical representations, statistical analyses, dashboards, or exceptions-based reporting, among other methods.[253] Boards should work with valuation designees to determine what information and the format of such information is most useful to the board.

In the Proposing Release, we provided a list of specific items that a board could review and consider, if relevant. These included a number of data-driven reporting items like reports regarding portfolio holdings whose price has changed outside of pre-determined ranges over time, reports regarding stale prices, and analyzing trends in the number of the fund's portfolio holdings that received a fair value.[254]

A number of commenters objected to this list, suggesting that boards and advisers would see these items as mandatory, leading to advisers providing unwanted data to boards in an abundance of caution.[255] The items we identified in the Proposing Release were intended to provide a list of examples of the types of information that a board could request to facilitate data-driven reviews of the fair value process if the board found such information helpful. We continue

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252 *See, e.g.,* Capital Group Comment Letter; TRP Comment Letter. *But see* CFA Institute Comment Letter (arguing that the results of testing methods such as calibration/back-testing can assist in identifying issues with methodologies, including poor performance or conflicts of interest).

253 *See* ABA Comment Letter (recommending we require the production of narrative summaries of testing results).

254 *See* Proposing Release, *supra* footnote 2, at 46-47.

255 *See* Fidelity Trustees Comment Letter; ICI Comment Letter; IDC Comment Letter; ABA Comment Letter (further suggesting that it should be incumbent upon the adviser, similar to the requirements of section 15(c) or 17 CFR 270.12b-1, to provide this type of information, rather than upon the board to request it); MFDF Comment Letter; Fidelity Comment Letter; Vanguard Comment Letter; Capital Group Comment Letter; SIFMA AMG Comment Letter; *see also* Federated Hermes Comment Letter.

to believe that boards should request, and valuation designees should provide, such relevant trend dashboards and other analytical tools that the board believes it needs in order to perform appropriate oversight.[256] However, the final rule will not require the production of any particular data or data tool unless the board requests it. We also continue to believe that the types of potential reporting items included in the proposal may be helpful for some boards. They are not mandatory, however. Boards should use their judgment in determining what types of optional reporting they wish to receive beyond the required reporting contained in the final rule.

b) Prompt Board Notification and Reporting

With modifications made to address comments received on this aspect of the proposal, the final rule will require the valuation designee to provide a written notification of the occurrence of matters that materially affect the fair value of the designated portfolio of investments (defined as "material matters") within a time period determined by the board, but in no event later than five business days after the valuation designee becomes aware of the material matter.[257] Material matters in this instance include, as examples, a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process or of material errors in the calculation of net asset value.[258] The valuation designee must also provide such timely follow-on reports as the board may reasonably determine are appropriate.[259] This process is designed to ensure that the valuation designee notifies the

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256 *See, e.g.,* Capital Group Comment Letter (stating that reporting of trends, outliers, and similar analysis of price overrides and challenges would be more helpful for board oversight than requiring all price overrides or challenges to be reported).

257 The proposed rule would have required prompt reporting regarding matters associated with the adviser's process that had this effect. The purpose of this requirement is to inform boards quickly of issues associated with fair value determinations that may require their immediate attention. *See* Proposing Release, *supra* footnote 2, at 49. We have updated the text of rule 2a-5 to clarify that this reporting is not limited to issues relating to the valuation designee's process.

258 Rule 2a-5(b)(1)(ii). *See also supra* footnotes 243 through 249 and accompanying text (discussing "materiality") and *infra* footnote 272 through 274 and accompanying text (discussing price errors).

259 Rule 2a-5(b)(1)(ii). The notifications or reports, like the periodic reports discussed above, must also include such information as may be reasonably necessary for the board to evaluate the matter covered in the report. *See* rule 2a-5(b)(1) and *supra* footnotes 243-256 and accompanying text. This information need not be voluminous, particularly the prompt notification. If boards want more information, however, they should seek it out.

board of certain issues that may require its immediate attention in a timely manner, but also empower boards to seek the appropriate level of follow-up reporting that they need to exercise appropriate oversight.

The proposal included a reporting requirement that would have required prompt reporting on matters that could have materially affected the fair value of the designated portfolio of investments.[260] Commenters argued that this requirement could be interpreted broadly and would result in excessive reporting, particularly in relation to the requirement to report material changes in valuation risks.[261] They also suggested it could involve the board in the day-to-day process of determining investments' fair values despite the designation of that function to the adviser,[262] and could open the valuation program to post-facto questioning by third parties, particularly the proposed requirement to promptly report matters that "could have" impacted valuations.[263]

Some suggested alternatives, such as the adviser making a prompt notification within the prescribed period and then subsequently providing a report to the board following an assessment of the issue as soon as reasonably practicable.[264] Others suggested that the specific items required to be promptly reported, such as significant deficiencies or material weaknesses in the design or implementation of the adviser's fair value determination process or material changes to

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260 Proposed rule 2a-5(b)(1)(ii). The proposed rule identified significant deficiencies or material weaknesses in the design or implementation of the adviser's fair value determination process or material changes in the fund's valuation risks, but not material errors in the calculation of net asset value, as examples of these material matters. *Id. See also* Proposing Release, *supra* footnote 2, at n.115 and accompanying text. Also, in the Proposing Release, we provided guidance that advisers could take an additional three days to determine the materiality of the issue at hand. *Id.* at 49-50.

261 *See, e.g.,* ICI Comment Letter; IAA Comment Letter (stating that a significant increase in price challenges should not be considered a material valuation risk); *see also* Federated Hermes Comment Letter.

262 *See, e.g.,* Fidelity Trustees Comment Letter; ICI Comment Letter; IDC Comment Letter; BlackRock Trustees Comment Letter; ABA Comment Letter; Fidelity Comment Letter.

263 *See, e.g.,* Fidelity Trustees Comment Letter; JPMAM Comment Letter; ICI Comment Letter; IDC Comment Letter; Murphy Comment Letter; *see also* Federated Hermes Comment Letter. *See also supra* footnote 248 and accompanying text (discussing the final rule's treatment of matters that the valuation designee or fund's auditors have determined "could have" materially affected fair value).

264 *See* JPMAM Comment Letter; Murphy Comment Letter; John Hancock Comment Letter.

the fund's current valuation risks, be clarified or made in the periodic reports instead.[265] Some suggested that the prompt reporting requirement be eliminated altogether,[266] or that the final rule should allow boards or advisers to set reporting parameters.[267]

The purpose of this requirement is to ensure that boards receive timely information that demands their immediate attention. We believe that it is critical for appropriate oversight under the final rule that the board be kept informed of material changes or events in a timely manner, rather than waiting until the next periodic report. However, we also agree that boards should be receiving information tailored to this purpose. As a result, in a modification from the proposal, the final rule will require that the valuation designee provide a prompt written notification of the material matter,[268] with such follow-on reporting as the board may determine[269] appropriate.[270] Examples of material matters that would need to be reported under this provision include significant deficiencies or material weaknesses in the design or effectiveness of the valuation

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265 *See, e.g.,* ICI Comment Letter; TRP Comment Letter; Vanguard Comment Letter (regarding a significant increase in price challenges as a material change to the fund's current valuation risk); Capital Group Comment Letter; *see also* Federated Hermes Comment Letter.

266 *See* ICI Comment Letter; IDC Comment Letter; BlackRock Trustees Comment Letter; MFDF Comment Letter; AIMA Comment Letter; *see also* Federated Hermes Comment Letter.

267 *See, e.g.,* Fidelity Comment Letter; Stradley Comment Letter; NYC Bar Comment Letter; Guggenheim Comment Letter; Vanguard Comment Letter; *see also* Duff & Phelps Comment Letter.

268 Some commenters suggested that the prompt reporting element in particular should be oral rather than in writing. *See* JPMAM Comment Letter; John Hancock Comment Letter; SIFMA AMG Comment Letter; AIMA Comment Letter; MFS Comment Letter. We believe that it is important to ensure that records are kept of these notifications and thus the notification must be in writing. Rule 2a-5(b)(1). However, the final rule does not prescribe the information that must be included in the written notification, and advisers may, if appropriate, provide a brief written notification (*e.g.,* in an email) of the issue and follow up with supplemental information.

269 Consistent with the guidance above regarding board oversight, the board can utilize this follow-up reporting process to inquire about the matter raised in the notification and take reasonable steps to see that matters identified in the notification are addressed. *See supra* footnote 212 and accompanying text.

270 The notifications and reports that will be required under this provision are records that will need to be maintained pursuant to new rule 31a-4. *See* rule 31a-4(b)(1); *see also infra* section II.C. Further, to the extent that the board does seek follow-on reporting, appropriate records of that report will need to be maintained, consistent with the requirement to maintain appropriate documentation to support fair value determinations. *See* rule 31a-4(a). If such reporting occurs as part of the valuation designee's periodic reports required under the final rule, a separate record will not need to be maintained.

designee's fair value determination process[271] as well as material errors in the calculation of net asset value.[272] Some commenters had suggested that we set an NAV error threshold, similar to that generally utilized in the industry at $0.01 a share or 0.5% of the NAV, as the threshold for prompt reporting.[273] While we decline to establish that specific standard as what constitutes a "material error in the calculation of net asset value" for purposes of the final rule, we agree that relying upon that standard would not be unreasonable.[274]

Commenters also had concerns about the proposed three-business-day time period for making these reports, arguing that it was insufficient time to provide a meaningful report to the board.[275] Some suggested that we either remove or extend the specified reporting period.[276] We believe that it is important to specify some time period for these reports so that the board receives timely information within an appropriate window of time, but we agree with commenters that three business days may be insufficient time to prepare the necessary

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271 We have changed this requirement from the proposed "implementation" to "effectiveness" to clarify the intent of this provision and better align it with auditing concepts of internal control. This specific example was, as proposed, based upon these auditing concepts. *See* Proposing Release, *supra* footnote 2, at n.115. This change should help address comments that the proposed rule was insufficiently clear as to when this report is needed as it will now be tied to the auditing concepts with which funds and valuation designees are already familiar. *See supra* footnote 261 and accompanying text.

272 Rule 2a-5(b)(1)(ii). Some commenters had recommended this as a reporting item and we agree that valuation designees should promptly notify boards of this issue. *See* Advisor's Inner Circle Trustees Comment Letter. *See generally* BlackRock Trustees Comment Letter; ABA Comment Letter (arguing that "material" in the reporting context should be considered synonymous with material NAV errors); Murphy Comment Letter (recommending this as a quarterly reporting item); TRP Comment Letter (recommending this as a quarterly reporting item); Vanguard Comment Letter (suggesting that "material" for prompt reporting purposes could be based upon an NAV error threshold test).

273 *See* ABA Comment Letter; Vanguard Comment Letter.

274 *See also supra* footnotes 243 through 249 and accompanying text (discussing materiality).

275 *See, e.g.,* Sullivan Comment Letter; JPMAM Comment Letter; MFDF Comment Letter; Fidelity Comment Letter; TRP Comment Letter (recommending we incorporate the concept of "reasonable diligence" from certain "Dear CFO" staff letters relating to tax liabilities); John Hancock Comment Letter (stating that this is particularly difficult timing when an adviser would need to consult with a sub-adviser); *see also* ABA Comment Letter (stating that three days was arbitrary); Duff & Phelps Comment Letter (stating that additional time may be necessary); Federated Hermes Comment Letter; American Funds Trustees Comment Letter; MFS Comment Letter; Advisor's Inner Circle Trustees Comment Letter. *But see* NYC Bar Comment Letter (stating that three days was sufficient if the adviser is simply informing the board of an error in implementation or risk of material effects on the valuation of the fund's portfolio): University of Miami Comment Letter.

276 *See, e.g.,* Sullivan Comment Letter; ICI Comment Letter; IAA Comment Letter; AIMA Comment Letter; NYSSCPA Comment Letter; ABA Comment Letter (recommending ten days).

communication. As a result, we are extending the period to five business days to give valuation designees sufficient time to coordinate and prepare communications for the board regarding a material matter that meets the standard for prompt notification.[277] In light of the changes discussed above, we are not extending the period beyond five business days as we believe it is important that boards receive information about material matters as promptly as practicable. However, the final rule also empowers boards to require that valuation designees make this notification within a shorter time frame should boards determine that more timely notification or reporting is necessary for their oversight of these matters.

Under this revised requirement, a valuation designee must promptly notify the board of material matters related to valuation controls or errors that either the valuation designee has identified itself or that the valuation designee has been notified of by an independent third party, including the fund's auditor. We believe that the valuation designee should promptly determine the materiality of matters it identifies consistent with its fiduciary duties and then notify the board within the five business day period after determining that the matter is material. In cases where the materiality of a matter is immediately apparent, the designee would report the material matter to the board within the five business day period.[278] If, after 20 business days of becoming aware of the relevant valuation matter, the designee has not been able to determine the matter's materiality, we would expect the designee to then notify the board of its ongoing evaluation of the matter within the five-business-day prompt reporting period.[279] A valuation designee should

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[277] As discussed in more detail below, the final rule does not require valuation designees to complete their materiality assessment within this five-day window. *See infra* footnote 280 and accompanying text. As a result, once materiality has been determined, valuation designees must notify the board within five business days.

[278] If the materiality of the event is not in question, such as when an independent third party (for example an auditor), notifies the valuation designee of a material matter and that notification includes a conclusion as to the impact of the material matter upon the fund's portfolio or the fund's control deficiencies' severity, then the five business day notification period is triggered immediately.

[279] We believe that taking longer than 20 business days to determine materiality, or at least begin the five business day period to notify the board if materiality cannot be determined that quickly, would be excessive and thus not consistent with the promptness contemplated by the reporting requirement.

act promptly in seeking to determine the materiality of a matter, and not take the 20 business days as a matter of course, in order to enable the board to provide effective oversight. This is a change from the proposal, where we would have required materiality determinations to be made within three business days.[280]

In combination, these changes should clarify and focus the prompt reporting and provide boards and valuation designees with more flexibility. As adopted, the final rule also should be better suited for the ongoing dialogue between boards and valuation designees that commenters stressed as important when the board is exercising oversight,[281] in that it gives boards discretion to get in-depth analysis they may need to provide appropriate oversight rather than mandating a quickly produced formal report. We also believe that these modifications make clear that the board's role under rule 2a-5, where the board has designated the valuation designee to perform fair value determinations, is one of oversight and that the final rule's prompt reporting requirements will help boards to effectively perform this function.

Some commenters recommended that we permit a designated board member, such as an independent board member, to receive the prompt report.[282] We believe that the reports should be made to the board members that are tasked with carrying out appropriate oversight over valuations, which can be a committee. Therefore, the final rule, consistent with the proposal, permits reporting to either the full board or a designated committee of such board composed of a majority of directors who are not interested persons of the fund.[283]

3. Specification of Functions

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280 The proposed rule would have provided three business days to report to the board on these matters, and the Proposing Release clarified that an adviser would have been permitted to take an additional three business days to verify and make a final determination of the matter's materiality prior to reporting to the board. Proposing Release, *supra* footnote 2, at 50-51.

281 *See, e.g.,* BlackRock Trustees Comment Letter; MFS Comment Letter.

282 *See* Murphy Comment Letter (stating that such an approach would be helpful with small fund boards); Fidelity Comment Letter; AIMA Comment Letter.

283 Rule 2a-5(e)(3) ("board" defined as either fund's entire board of directors or designated committee of such board composed of majority of directors who are not interested persons of the fund).

We are adopting the specification of functions requirement largely as proposed. Under the final rule, if the board designates the performance of fair value determinations to a valuation designee, rule 2a-5 will require the valuation designee to specify the titles of the persons responsible for determining the fair value of the designated investments, including by specifying the particular functions for which the persons identified are responsible.[284] Consistent with this requirement, the specific personnel with duties associated with price challenges should be identified, including those with the authority to override a price, along with the roles and responsibilities of such persons, and the valuation designee is required to establish a process for the review of price overrides.[285] Finally, the final rule requires the valuation designee reasonably to segregate fair value determinations from the portfolio management of the fund such that the portfolio manager may not determine, or effectively determine by exerting substantial influence on, the fair values ascribed to portfolio investments.[286]

Commenters generally supported these provisions.[287] One commenter, however, stated that the proposed rule lacked clarity as to which individuals are required to be identified and stated that "little appears to be gained by the mechanical exercise" of naming individuals and their titles, which may be generic, and identifying with specificity their roles in the valuation function.[288] We disagree with the commenter because these provisions cannot be satisfied by simply listing the generic titles of those involved in valuation. As we stated in the Proposing

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284 Rule 2a-5(b)(2). To comply with this requirement, the fair value policies and procedures adopted under rule 38a-1 generally should specify the titles of the persons responsible for determining the fair value of the designated investments and should specify the particular functions for which persons with the identified titles are responsible. Similarly, if the valuation designee uses a valuation committee or similar body to assist in the process of determining fair value, the fair value policies and procedures should generally describe the composition and role of the committee, or reference any related committee governance documents as appropriate. *See* Proposing Release, *supra* footnote 2, at text following n.117.

285 *See also* rule 2a-5(a)(4) (requiring the oversight of pricing services).

286 Rule 2a-5(b)(2). The valuation designee of an internally managed fund would also be required to reasonably segregate fair value determinations from the portfolio management of the fund.

287 *See, e.g.,* AIMA Comment Letter; ICI Comment Letter; ABA Comment Letter; Fidelity Comment Letter; Dechert Comment Letter.

288 *See* Sullivan Comment Letter.

Release, we believe, and other commenters agreed, that it is important for funds clearly to identify, in their fair value policies and procedures, the titles of persons, and a description of their roles and responsibilities, who make fair value determinations to enhance accountability and provide clear lines of responsibility.[289] We believe requiring the identification of the titles of the responsible individuals and a description of their roles will facilitate an effective fair value process and promote accountability.[290]

Additionally, commenters generally supported the proposed requirement that the adviser reasonably segregate fair value determinations from the portfolio management of the fund.[291] These commenters agreed with our assertions in the Proposing Release that a 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.[292] Three commenters stated that portfolio managers have "insurmountable" conflicts of interest because they are often compensated based on the returns of the fund.[293] These commenters urged the Commission to prohibit portfolio managers from participating in the process of fair value determinations in any way. Other commenters, however, stated that in many circumstances, the fund's portfolio manager may be the most knowledgeable person at an adviser regarding a fund's

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289 *See* Proposing Release, *supra* footnote 2, at n.118 and accompanying text. *See also, generally,* AIMA Comment Letter; ICI Comment Letter; ABA Comment Letter; Fidelity Comment Letter; Dechert Comment Letter. *See supra* section II.A.5.

290 *See, e.g.,* AIMA Comment Letter.

291 SBIA Comment Letter; AIMA Comment Letter; IVSC Comment Letter; Duff & Phelps Comment Letter; Stradley Comment Letter; Vanguard Comment Letter; MFS Comment Letter; Fidelity Comment Letter; American Bankers Association Comment Letter; Dechert Comment Letter. *See* Proposing Release, *supra* footnote 2, at text accompanying n.122.

292 *Id. 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 (noting that portfolio managers can be important sources of information about the value of securities, but there may be conflict of interest concerns when portfolio managers select fair values that boost a fund's performance, particularly when the compensation of the portfolio manager is based on the fund's performance).

293 Better Markets Comment Letter; CFA Institute Comment Letter; University of Miami Comment Letter.

portfolio holdings and it is appropriate for him or her to provide input into the process for determining the fair value of fund investments.[294] Two commenters also stated the segregation requirement may create challenges for smaller managers due to their limited resources and personnel, but recognized the importance of appropriately mitigating portfolio managers' biases or conflicts of interest.[295] One commenter stated that, by requiring a fund reasonably to segregate portfolio management from the *process* of making fair value determinations in the text of rule 2a-5, the condition could be read to prohibit any involvement of fund portfolio management in any part of the process of making fair value determinations.[296]

We continue to believe that our proposed approach strikes the appropriate balance. The final rule will not prohibit portfolio managers from participating in the process of fair value determinations because of the unique insights that portfolio management may have regarding the value of fund holdings. Keeping the functions reasonably segregated in the context of fair value determinations should help mitigate the possibility that a portfolio manager's competing incentives diminish the effectiveness of fair value determinations. However, in a change from the proposal, the final rule would remove the phrase "process of" from this subsection of rule 2a-5. This change is meant to clarify that the segregation requirement would not prevent portfolio managers from providing inputs that are used in the process for determining fair value, as raised by one commenter.[297] However, in a change from the proposal, the final rule clarifies that, to

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294 SBIA Comment Letter; AIMA Comment Letter; IVSC Comment Letter; Stradley Comment Letter; Vanguard Comment Letter; MFS Comment Letter; Fidelity Comment Letter; American Bankers Association Comment Letter; Dechert Comment Letter. One commenter further argued that the Commission should mandate the involvement of portfolio managers in the valuation process because they have "the most relevant investment specific information pertaining to an investment." Duff & Phelps Comment Letter.

295 Duff & Phelps Comment Letter; American Bankers Association Comment Letter (suggesting that, in certain situations where segregation may be burdensome, the Commission should allow alternative processes for managing conflicts, including establishing reconciliation procedures that are designed to protect against improper valuation of fund investments).

296 Dechert Comment Letter.

297 Dechert Comment Letter. *See also* Proposing Release, *supra* footnote 2, at text following n.122 (stating that the reasonable segregation requirement is not meant to indicate that portfolio management must necessarily be subject to a communications "firewall").

satisfy the reasonable segregation requirement, the portfolio manager may not determine, or effectively determine by exerting substantial influence on, the fair values ultimately ascribed to portfolio investments.[298] A portfolio manager determining the fair value of fund investments would not be consistent with the reasonable segregation of functions required by the final rule.

As discussed in the Proposing Release, this requirement is designed to address concerns regarding a portfolio manager's conflicts of interest while recognizing the important perspective and insight regarding the value of fund holdings that portfolio management personnel can provide.[299] Reasonable segregation of functions facilitates these important checks and balances, and funds could institute this requirement through a variety of methods, such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel.[300] We recognize that this requirement may create certain challenges for smaller advisers and internally managed funds due to their limited numbers of personnel, but we believe that this requirement is necessary to manage potential conflicts of interest. Additionally, to alleviate some of these challenges, the final rule's reasonable segregation approach is designed 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 a particular fund. However, the final rule clarifies that a fund should limit the extent of influence portfolio managers may have on administration of the fair value process. If portfolio managers provide a significant amount of input on the fair value of an investment, the segregation process should be appropriately rigorous and robust to mitigate any potential conflicts of interest. For example, in such a circumstance, the valuation designee could, as part of its reasonable

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298 An example of effectively determining by exerting substantial influence would be if the fair values ascribed to portfolio investments are based solely on information provided by the portfolio manager,

299 *See* Proposing Release, *supra* footnote 2, at text following n.122.

300 *See* American Bankers Association Comment Letter.

segregation process, seek to provide independent voices as a check on any potential conflicts of interest to the extent appropriate.[301]

C. Recordkeeping

We are adopting new rule 31a-4 that applies to both registered investment companies and business development companies[302] to contain the recordkeeping requirements associated with the final rule.[303] Rule 31a-4 will require, substantially as proposed as part of rule 2a-5, funds or their advisers to maintain appropriate documentation to support fair value determinations.[304] In addition, rule 31a-4 provides that, in cases where the board has designated the performance of fair value determinations to a valuation designee, the reports and other information provided to the board must include a specified list of the investments or investment types for which the valuation designee has been designated.[305] These records will, in a change from the proposal,[306] generally be required to be maintained for six years, the first two in an easily accessible place.[307] In another change from the proposal, rule 31a-4 will require funds or their advisers to maintain

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301 *See* Proposing Release, *supra* footnote 2, at n.122. *See also supra* footnote 189 (noting that an evaluation designee, once designated by the board, could seek to obtain the assistance from other parties such as the fund administrator).

302 *See* section 64 of the Act (generally applying section 31 of the Act to business development companies to the same extent as if they were registered closed-end investment companies).

303 Except as discussed in more detail below, the provisions of this rule are the same as the recordkeeping requirements proposed to be part of rule 2a-5. *See* proposed rule 2a-5(a)(6) and (b)(3).

304 Rule 31a-4(a).

305 Rule 31a-4(b).

306 We proposed a five-year retention period for these records. *See* proposed rule 2a-5(a)(6) and (b)(3). Other than the list of designated investments, this retention period will, as proposed, begin when the determination is made for documentation to support fair value determinations and from the end of the relevant fiscal year for valuation designee reports. Rule 31a-4(a) and (b). *Cf.* Murphy Comment Letter (questioning the beginning of the retention period) and *infra* footnote 307 and accompanying text (discussing the retention period for the list of designated investments).

307 The list of designated investments will be required to be kept for a period beginning with the designation and ending at least six years after the end of the fiscal year in which the designation was terminated, in an easily accessible place until two years after such termination, instead of the proposed period of five years beginning at the end of the fiscal year in which the investments or investment types were assigned to the adviser, the first two years in an easily accessible place. *See* rule 31a-4(b)(2) and proposed rule 2a-5(b)(3)(ii). We had requested comment on, among other things, whether the proposed holding periods were sufficient to evidence compliance with the proposed rule. *See* Proposing Release, *supra* footnote 2, at 57. While we did not receive any specific comments on this point, we are concerned that in cases where a valuation designee's appointment lasts longer than five or six years, third parties, including Commission staff, will not have access to this information.

appropriate documentation to support fair value determinations, rather than requiring a fund or adviser to keep records of the specific methodologies applied and assumptions and inputs that form the basis of the fair value determination in all cases. Lastly, as proposed, the fund will be required to maintain these records unless the board has designated the performance of fair value determinations to the fund's investment adviser. In that case, the investment adviser will maintain the records.[308]

Comments on the recordkeeping aspects of the proposal were mixed, with some commenters broadly agreeing with them,[309] and others stating that the proposed requirements would add significant additional costs.[310] Specifically, these commenters stated that the proposed requirement to maintain documentation to support fair value determinations, including information regarding the specific methodologies applied and the assumptions and inputs considered when making fair value determinations, would result in the adviser needing to obtain and retain significant amounts of data that it would not otherwise obtain and retain when it utilizes a pricing service, and could hamper flexibility in making fair value determinations.[311]

One commenter suggested that the proposed recordkeeping requirements were more appropriate as a rule under section 31 of the Act, stating that this would both help centralize investment company recordkeeping provisions and would also ensure that a failure to keep the required records would not lead to a board being found to have not fair valued in good faith.[312]

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308 Rule 31a-4(c).

309 *See* IVSC Comment Letter; Council of Institutional Investors Comment Letter; CFA Institute Comment Letter. Some commenters approved of the proposed recordkeeping requirements, but only for records created by the fund or adviser, not records of a pricing service. *See* Fidelity Comment Letter; TRP Comment Letter; Vanguard Comment Letter.

310 *See, e.g.,* ICI Comment Letter; Fidelity Comment Letter; Vanguard Comment Letter; Guggenheim Comment Letter (asserting that funds or advisers would need to hire additional personnel to comply with the rule as proposed); and Guggenheim Trustees Comment Letter. *But see* Comment Letter of Elena Davidson (July 20, 2020) ("Davidson Comment Letter") (suggesting that the Commission provided ample reason to believe that the costs of compliance would be on the smaller side).

311 *See, e.g.,* ICI Comment Letter; IDC Comment Letter; SSGA Comment Letter; Sullivan Comment Letter; ICE Data Comment Letter (stating that pricing services would need to increase fees to compensate for the demands for records under the proposed regime).

312 Murphy Comment Letter.

We agree, and are therefore moving these amended recordkeeping requirements to a new rule under section 31. Another suggested that these requirements are duplicative with the existing recordkeeping rules adopted under section 31 of the Act.[313] While some records currently required to be maintained pursuant to the rules adopted under section 31 of the Act may be the appropriate documentation to support fair value determinations in some circumstances,[314] they may not always be sufficient to meet that standard. Thus, we do not believe that rule 31a-4's recordkeeping requirements are duplicative of the existing rules adopted under section 31.[315]

A number of commenters also recommended that we tie the recordkeeping requirements to the three-tier fair value hierarchy within U.S. GAAP[316] or otherwise not require obtaining or maintaining detailed records regarding the level 2 categorized fair value measurements of securities for which funds use pricing services.[317] These commenters stated that, because the fund or adviser would not have access to the appropriate level of information on the pricing service's specific inputs considered or assumptions applied in each particular case, the proposed requirement would be a significant departure from industry practice. Instead, these commenters asked that we only require detailed recordkeeping to support fair value determinations for those investments for which the fund or valuation designee establishes or applies its own

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313 NYC Bar Comment Letter.

314 Schedules evidencing and supporting each computation of net asset value as required under 17 CFR 270.31a-2(a)(2) ("rule 31a-2") are examples of records that could also be considered appropriate documentation to support fair value determinations.

315 Also, the reports to the board and specified list of designated investments that will be required to be maintained under rule 31a-4 are not clearly required as part of the existing section 31 rules. *See also* Compliance Rules Adopting Release, *supra* footnote 82, at n.94 (adopting a similar requirement for rule 38a-1 for similar reasons).

316 ASC Topic 820 categorizes inputs to valuation techniques used to measure fair value into three levels. The fair value hierarchy gives the highest priority to quoted, observable inputs (level 1) and the lowest priority to unobservable inputs (level 3). *See infra* section II.D.

317 *See* TRP Comment Letter; Franklin Comment Letter; MFS Comment Letter; Fidelity Comment Letter; John Hancock Comment Letter; *see also* Vanguard Comment Letter (stating that the prosed requirements differ from industry practice); SIFMA AMG Comment Letter.

methodologies.[318] A number of commenters suggested that we provide additional guidance regarding exactly what records fit within the rule's requirements.[319] One commenter requested that the Commission confirm that the view that funds and advisers must maintain documentation sufficient for a third party to verify the fair value determination is not intended to mandate documentation detailed enough to fully recreate it.[320]

We believe that the requirement to maintain appropriate documentation to support fair value determinations should include documentation that would be sufficient for a third party, such as the Commission's staff, not involved in the preparation of the fair value determinations to verify, but not fully recreate, the fair value determination, as further described below.[321] We understand that advisory personnel currently produce working papers supporting fair value determinations that include, for example, copies of internally developed valuation models, including inputs and assumptions used therein and relevant supporting documentation.[322] These records that valuation designees currently create in the ordinary course of performing fair value determinations are examples of the types of records that we consider to be "appropriate documentation to support fair value determinations."

In a change from the proposal, we are not requiring detailed records relating to the specific methodologies a pricing service applied and the assumptions and inputs a pricing service considered when providing each piece of pricing information as we are persuaded that such a requirement would be impractical. Rather, we believe appropriate documentation to support a fair value determination that takes into account inputs from pricing services consists of the

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318 *See* ICI Comment Letter (noting this approach is similar to that in rule 22e-4); IDC Comment Letter; SSGA Comment Letter; Fidelity Comment Letter; TRP Comment Letter; Franklin Comment Letter; Vanguard Comment Letter; Capital Group Comment Letter; SIFMA AMG Comment Letter; Dechert Comment Letter; ICE Data Comment Letter; Dimensional Comment Letter.

319 *See* Harvest Comment Letter; Guggenheim Comment Letter.

320 Guggenheim Comment Letter.

321 *See* Proposing Release, *supra* footnote 2, at n.74 and accompanying text.

322 *See, e.g., infra* section III.B.2.h.

records related to the fund or valuation designee's initial due diligence investigation prior to selecting a pricing service and records from its ongoing monitoring and oversight of the pricing services.[323] As discussed above, for example, this diligence should consider the valuation methods or techniques, inputs, and assumptions used by the pricing service for different classes of holdings, and how they are affected as market conditions change, among other matters.[324] Other appropriate documentation also includes work papers created by the valuation designee while overseeing pricing services or testing fair value methodologies, such as those documenting the valuation designee's monitoring and conducting of price challenges, stale price analysis, and testing such as calibration or back-testing.[325] The fund or adviser will not be required to maintain the internal records of the pricing service or the specific inputs the pricing service used for each piece of pricing information it provides to the fund.

We also believe that different types of records will be appropriate depending on the security or fair value methodology used. For example, the documentation to support the fair value determination of an investment valued with level 3 inputs would typically require different and more extensive documentation[326] than an investment that was valued only with level 2 inputs. We expect that the records kept may vary based on a variety of factors, including the subjectivity of the inputs used in determining fair value (*e.g.* level 2 or level 3).

Under rule 31a-4, and consistent with proposed rule 2a-5, an adviser designated to perform fair value determinations will be required to maintain the relevant records.[327] While

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323 We expect that the type of documentation discussed in this paragraph would be the type of documentation that would be sufficient for a third party to verify the fair value determination as discussed in the text accompanying n 321.

324 *See also supra* section II.A.4 regarding various matters a board or valuation designee should consider in approving, monitoring, and evaluating pricing services.

325 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.

326 Examples of the records that may be needed for level 3 inputs include documentation supporting the inputs, assumptions, and calculation methodology used in determining fair value, for example selected financial models, financial reporting information, income or growth projections, or public company comparable data.

327 Rule 31a-4(c).

commenters disagreed about whether the fund or adviser should keep these records,[328] we continue to believe the adviser should maintain them when it is the valuation designee. As one commenter suggested,[329] the adviser would need to keep valuation records anyway. The reporting requirement should give boards the access to the documentation they deem necessary without mandating that the fund also directly hold these duplicative records.[330]

We are not expanding the records to be maintained under the rule as suggested by some commenters.[331] We believe that further recordkeeping requirements are not necessary because, as discussed above, we believe that the records required under rule 31a-4 should be sufficient to meet the purpose of the recordkeeping requirements, which is to assist third party oversight. We are also adopting as proposed the requirement to maintain records of the reports and other information provided to the board in accordance with rule 2a-5(b)(1) so that we and our staff will have access to them. Also, because we are not adopting the proposed requirement to establish fair value policies and procedures in light of the existing requirements of rule 38a-1, the final rule will not contain the proposed requirement to maintain copies of fair value policies and procedures, as policies and procedures adopted under rule 38a-1 have their own existing recordkeeping requirements.[332]

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328 *Compare* CFA Institute Comment Letter; Council of Institutional Investors Comment Letter; and VRC Comment Letter *with* Murphy Comment Letter and Sullivan Comment Letter.

329 *See* Sullivan Comment Letter.

330 For internally managed funds that have delegated the performance of fair value determinations to an officer or officers of the fund, the fund will need to preserve these records. *See* rule 31a-4(c). Also, we would expect that, in the event of a change in advisers, the fund will take appropriate action to ensure that the records are transferred. *Cf.* Murphy Comment Letter.

331 *See* IVSC Comment Letter (suggesting that the Commission require keeping records relating to the background details of valuation professionals); MFS Comment Letter (stating that the recordkeeping requirements should reflect the relevant details of prompt board reports by maintaining a log or meeting minutes).

332 Rule 38a-1(d)(1). *See supra* section II.A.5. *But see* Fidelity Comment Letter (stating that it would be appropriate to have a separate policies and procedures record retention requirement in rule 2a-5 and that the interplay between the rules was sufficiently explained in the Proposing Release).

Under the final rule, funds and advisers will be generally required to maintain these records for a total of six, rather than the proposed five, years.[333] We had proposed a five year period to align with the retention period of rule 38a-1. In light of the commenters noting the relationship between certain records required to be maintained under rule 31a-2 and rule 31a-4, we believe that aligning the retention period with rule 31a-2, regarding schedules evidencing and supporting each computation of net asset value, is more appropriate.

D. Readily Available Market Quotations

We are adopting the definition of readily available market quotations as proposed. 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.[334] Under section 2(a)(41) of the Investment Company Act, if a market quotation is readily available for a portfolio security, it must be valued at the market value. Conversely, if market quotations are "not readily available," a portfolio security value must be fair valued as determined in good faith by the board (or the valuation designee under the final rule).[335]

The final rule will provide that a market quotation is readily available for purposes of section 2(a)(41) of the Investment Company Act with respect to a security 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."[336] This definition is consistent with the definition of a level 1 input in the fair value

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333 *See* Duff & Phelps Comment Letter (recommending that the retention period mirror fund documents and "statutory requirements," stating that six or seven years is common). *But see* CFA Institute Comment Letter (agreeing with a five-year retention period).

334 Section 2(a)(41) requires the use of market values only for securities for which market quotations are readily available. Non-security holdings must always be fair valued regardless of whether readily available market quotations exist for that holding. *See also infra* footnote 338.

335 Section 2(a)(41). Neither the Investment Company Act nor the rules thereunder currently define "readily available."

336 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

hierarchy outlined in U.S. GAAP. Thus, under the final definition, a security will be considered to have readily available market quotations if its value is determined solely by reference to these level 1 inputs. Fair value, as defined in the Act and further defined in rule 2a-5,[337] therefore must be used in all other circumstances.[338]

Some commenters that addressed our proposed definition of readily available market quotations generally supported it.[339] However, some commenters asked that we treat all securities that are valued using level 2 inputs in the U.S. GAAP hierarchy, including evaluated prices, as also having readily available market quotations under our definition.[340] We believe that the best conceptual analogue for readily available market quotations are securities whose values are determined solely by reference to level 1 inputs, as we proposed. We also believe that this

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(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. *See also* Proposing Release, *supra* footnote 2, at n.129 and accompanying text.

337 We decline, as suggested by one commenter, to clarify that the final rule's definition of readily available market quotations only applies to determinations made pursuant to rule 2a-5. *See* Seward & Kissel Comment Letter. As discussed below, we believe that this definition is appropriate for all contexts under the Investment Company Act and its rules. *See infra* footnotes 359 through 364 and accompanying text.

338 Rule 2a-5(e)(2). *See also supra* section II.A.2. One commenter recommended that certain assets that are not considered securities under the Act but have readily available market quotations should be valued at market value rather than fair valued. *See* Comment Letter of Practus, LLP (July 21, 2020) ("Practus Comment Letter"). The Act requires boards to determine fair value for all assets other than securities regardless of the existence of readily available market quotations. *See* section 2(a)(41). However, as we noted in the Proposing Release, U.S. GAAP requires funds to maximize the use of relevant observable inputs and minimize the use of unobservable inputs in valuing any asset. *See* Proposing Release, *supra* footnote 2, at 59. As a result, we believe that application of U.S. GAAP would generally provide for consideration of this information in determining fair value.

339 AIMA Comment Letter; Better Markets Comment Letter; ICI Comment Letter; Murphy Comment Letter; Stradley Comment Letter ; Duff & Phelps Comment Letter. Other commenters asked that we go further, and depart from the binary approach laid out in the Act and instead mirror the approach established in U.S. GAAP that treats all values as fair values, but establishes a three-tier hierarchy of inputs that are used in making fair value determinations. Fidelity Comment Letter; TRP Comment Letter; Capital Group Comment Letter; Baillie Gifford Comment Letter. We have not modified the final rule as they suggested because the Investment Company Act provides a binary framework in section 2(a)(41) under which a security either has readily available market quotations or must be fair valued.

340 *See* Guggenheim Comment Letter (suggesting that not including bonds, which usually have level 2 inputs, would face a significant burden under this definition); IAA Comment Letter (stating that fund boards may treat some securities with level 2 inputs as having readily available market quotations); ICE Data Comment Letter. *But see, e.g.,* ICI Comment Letter (agreeing with the proposed definition).

approach is consistent with many funds' practices today.[341] We believe that level 2 inputs under the U.S. GAAP hierarchy are not consistent with the concept of readily available market quotations under the Act and therefore our final definition. Securities valued using level 2 inputs include securities that are not traded on an active market, and/or are valued using inputs other than quoted prices for the specific security (such as credit spreads).[342] Accordingly, we do not believe that securities valued with level 2 inputs are consistent with the definition of readily available market quotations.

As we stated in the proposal, under the final rule, evaluated prices are not readily available market quotations as they are not based upon unadjusted quoted prices from active markets for identical investments. [343] In addition, for the same reason, "indications of interest" and "accommodation quotes," would also not be "readily available market quotations" for the purposes of rule 2a-5(c).[344]

Two commenters asked whether certain pooled investment vehicle securities, such as those of funds that publish their NAV daily and issue and redeem shares at that NAV (such as mutual funds), or that are valued using their NAV as a practical expedient (such as many private fund shares),[345] would qualify as having readily available market quotations.[346] We understand

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341 *See, e.g.,* ICI Comment Letter.

342 ASC Topic 820-10-35-48.

343 *See* Proposing Release, *supra* footnote 2, at nn.133-134 and accompanying text; *see also* 2014 Money Market Fund Release, *supra* footnote 11, at text accompanying n.895.

344 *See* Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016) [81 FR 82142 (Nov. 18, 2016)], at nn.800-801 and accompanying text.

345 *See* ASC 820-10-35-59 through 35-62 in 820, a topic called "Measuring the Fair Value of Investment in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent) ("A reporting entity is permitted, as a practical expedient, to estimate the fair value of an investment within the scope of paragraphs 820-10-15-4 through 15-5 using the net asset value per share (or its equivalent, such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) of the investment, if the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date.").

346 *See* ICI Comment Letter (recommending that mutual funds and other pooled investment vehicles with daily NAVs be considered to have readily available market quotations); CFA Institute Comment Letter (recommending that we not consider private funds that utilize NAV as a practical expedient as having readily available market quotations).

that, under ASC Topic 820, an investment in a mutual fund or similar structure that has a readily determinable fair value per share that is determined and published and is the basis for current transactions,[347] such as a daily NAV for mutual fund shares, is generally considered to have observable level 1 inputs under U.S. GAAP.[348] Accordingly, we agree with the commenter and believe that such investments are generally consistent with the definition of having readily available market quotations under the final rule.

Conversely, securities that are valued using NAV as a practical expedient, like certain private funds, do not require disclosure of the level of input associated with them under the U.S. GAAP fair value hierarchy.[349] We understand that the fair value of those investments for which use of NAV as a practical expedient is permitted under U.S. GAAP may generally require less effort and resources than other securities without readily available market quotations because fair value measurement utilizing such a fund's NAV involves less subjectivity and more objective measures. Nevertheless, we believe that these securities generally do not have readily available market quotations under the final definition because their value is not based on unadjusted quoted prices.[350]

One commenter stated that securities exchanges such as NASDAQ or the NYSE often adjust prices to establish a closing price or address technical issues. This commenter asked that we clarify that by "unadjusted" we did not mean to disqualify securities adjusted by exchanges in

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347 *See* definition of readily determinable fair value, item c. with ASC 820-10-20. One commenter sought clarification as to whether the proposed definition was seeking to incorporate the concept of "readily determinable" fair value from U.S. GAAP as well. American Bankers Association Comment Letter. "Readily determinable" fair value is not utilized to value all securities but for certain limited purposes under U.S. GAAP. Specifically the concept is similar but narrower in that it only applies with respect to equity securities. While readily determinable is a similar concept to "readily available market quotations" in that it utilizes similar concepts (*e.g.*, it references prices or quotations of securities exchanges), it is not what we are utilizing for this definition.

348 Investments in mutual fund shares are not valued using NAV as a "practical expedient." *See* ASC 820-10-35-54B. *See also* ICI Comment Letter.

349 *See* Proposing Release, *supra* footnote 2, at n.213. *See also* ASC 820-10-65-7.

350 As under our proposal, for purposes of our economic analysis we assume that such securities had no readily available market quotations, and would be thus fair valued under the final rule. *See* Proposing Release, *supra* footnote 2, at n.213.

this way.[351] We agree. The word unadjusted in the final definition refers to adjustments in market prices made by the fund or valuation designee, not adjustments made by the exchange on which the security is listed.

Consistent with the requirements for preparing fund financial statements,[352] we will presume a fair value methodology not determined in accordance with U.S. GAAP to be misleading or inaccurate and thus not an appropriate methodology under the final rule.[353] U.S. GAAP requires the maximization of the use of relevant observable inputs and minimization of the use of unobservable inputs. However, under U.S. GAAP there are circumstances where otherwise relevant observable inputs become unreliable.[354] Consistent with this, we will generally presume that a quote would be unreliable under final rule 2a-5(c) 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 the final rule funds would, consistent with U.S. GAAP, 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.[355] In such circumstances, the quote would be unreliable and the fund would need to fair value the security.

A number of commenters raised concerns that the proposed definition of readily available market quotations may affect current practices on cross trades under 17 CFR 270.17a-7 ("rule

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351 Practus Comment Letter.

352 *See* 17 CFR 210.4-01(a)(1).

353 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.

354 *See* Proposing Release, *supra* footnote 2, at n.131 and accompanying text and ASC Topic 820-10-35-41C (outlining circumstances when a reporting entity shall make an adjustment to a Level 1 input).

355 *See* ASC Topic 820-10-35-41C at b; *see also supra* footnote 77 and accompanying text. One commenter suggested that these adjustments are not required, which is inconsistent with our understanding of ASC Topic 820-10-35-36B and 35-41C. *See* NYC Bar Comment Letter.

17a-7").[356] For a fund to engage in a cross trade under rule 17a-7, the security first must have a "readily available market quotation" and then the transaction must meet the other conditions of that rule.[357] These commenters stated that funds and their affiliates regularly engage in cross trades of certain fixed-income securities that they believed would not qualify as having readily available market quotations under the proposed definition, and asked that we clarify that the proposed definition was not meant to disrupt current cross-trading practices.[358]

The definition of readily available market quotations that we are adopting will apply in all contexts under the Investment Company Act and the rules thereunder, including rule 17a-7.[359] In the adopting release for rule 17a-7, the Commission stated that "[t]he phrase 'which market quotations are readily available' also is found in section 2(a)(41) of the Act and rule 2a-4 and is intended to have the same meaning ascribed to it in those other provisions."[360] Further, the Commission has previously suggested that active secondary markets are an important indicator of readily available market quotations.[361] We continue to believe it is important to have a consistent definition of the term in all contexts, including in rule 17a-7, where it serves to ensure that there is an independent basis for determining the value of securities.

We recognize that whenever we define a term, to the extent market participants are currently engaged in practices that are not consistent with that definition, they will need to

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356 *See, e.g.,* ICI Comment Letter; Capital Group Comment Letter.

357 *See* rule 17a-7.

358 *See, e.g.,* ICI Comment Letter; Murphy Comment Letter. One commenter noted that they agreed with the Fixed Income Market Structure Advisory Committee recommendation on reform of rule 17a-7. *See* https://www.sec.gov/spotlight/fixed-income-advisory-committee/preliminary-recommendation-re17a-7.pdf.

359 *See, e.g.,* Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof, Investment Company Act Release No. 11136 (Apr. 21, 1980) [45 FR 29067 (May 1, 1980)] ("17a-7 Proposing Release"), at 12-13; Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof, Investment Company Act Release No. 11676 (Mar. 10, 1981) [46 FR 17011 (Mar. 17, 1981)] ("17a-7 Adopting Release") at 10 ("If the rule were expanded to include securities for which market quotations are not readily available, the independent basis for determining the value of securities would be eliminated.").

360 *See* 17a-7 Proposing Release, *supra* footnote 359, at n.16.

361 17a-7 Adopting Release *supra* footnote 359, at 7 (noting the importance of active secondary markets to provide an independent basis for cross-trade pricing).

conform their practices. As a result, certain securities that had been previously viewed as having readily available market quotations and being available to cross trade under rule 17a-7 may not meet our new definition and thus would not be available for such trades.[362] We also understand that many cross trades today are done taking into consideration certain letters by our staff that address, among other things, the application of the term readily available market quotations in the context of certain transactions under rule 17a-7.[363] The staff is reviewing these letters to determine whether these letters, or portions thereof, should be withdrawn. Separately, consideration of potential revisions to rule 17a-7 is on the rulemaking agenda.[364] We welcome input from the public as we undertake our consideration of rule 17a-7.

E. Rescission of Prior Commission Releases

As proposed, we are rescinding ASR 113 and ASR 118 in their entirety. We believe that rescission is appropriate because the guidance included in ASR 113 and ASR 118 is superseded or made redundant by the adoption of rule 2a-5 and by the requirements under the current accounting and auditing standards.[365]

Commenters generally supported the rescission of ASR 113 and ASR 118.[366] These commenters agreed with our assertion in the Proposing Release that the guidance within the ASRs is not inconsistent with current accounting standards, but they are not considered essential

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362 We discuss in the economic analysis section below the impact that the adoption of this definition may have on such fund cross trading practices. *See infra* section III.D.5

363 *See, e.g.,* United Municipal Bond Fund, SEC Staff No-Action Letter (Jan. 27, 1995) and Federated Municipal Funds, SEC Staff No-Action Letter (Nov. 20, 2006).

364 *See* Spring 2020 Securities and Exchange Commission Regulatory Actions, *available at* https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235&csrf_token=1A4EE40E5F597FA80ECBE64464FA72F1716FCD8F60FDF1D26B9A8644E274D25057FE57666F0C582CC5575C6CC8DC0DCE11D3.

365 *See* Proposing Release, *supra* footnote 2 at n.150.

366 *See* ICI Comment Letter; Comment Letter of PricewaterhouseCoopers LLP (July 21, 2020) ("PWC Comment Letter"); KPMG Comment Letter; ABA Comment Letter; Comment Letter of Ernst & Young LLP (July 20, 2020) ("E&Y Comment Letter"); Council of Institutional Investors Comment Letter; MFDF Comment Letter, Duff & Phelps Comment Letter; Invesco Comment Letter; Federated Hermes; Comment Letter of Charles E. Andrews, et al. (July 21, 2020) ("Capital Group Directors Comment Letter"); Capital Group Comment Letter.

or additive to the existing accounting standard framework.[367] One commenter stated that at a minimum the Commission should retain ASR 118's interpretive guidance that permits fund boards to appoint persons to assist them in making fair value determinations, and to make actual calculations pursuant to the board's discretion.[368] Some commenters opposed rescinding ASRs 113 and 118, stating that certain specific fair value matters are not covered in the relevant accounting standards and that certain content within those releases should be reissued or restated by the Commission.[369] Other commenters disagreed, generally stating that valuation matters are addressed in the principles and framework of ASC Topic 820 and the concepts that are necessary to retain are now either included in the relevant accounting standards or were included in the rule as proposed.[370]

One commenter argued that we should retain the ASRs, as it believed that the ASRs addressed certain fund specific issues, such as those related to the valuation of "odd lots" it believed were not addressed in U.S. GAAP.[371] Others specifically disagreed with this point, and argued that the principles of ASC Topic 820 and related U.S. GAAP standards address such "odd lot" cases.[372] We agree that the odd lot valuation practices, such as those that occurred in the cases referenced by the commenter (*e.g.*, a fund with an investment, held in an odd-lot quantity, valued at a round-lot price when the entity has no ability to access the round-lot market to exit such investment at the measurement date) do not reflect an appropriate methodology consistent with the principles of ASC Topic 820 and the existing U.S. GAAP framework.

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367 *See* ICI Comment Letter.

368 *See* Scheidt Comment Letter 2.

369 *See* Scheidt Comment Letter 1; Scheidt Comment Letter 2; NYC Bar Comment Letter and Vanguard Comment Letters that highlight reaffirming certain concepts from ASR 118 and the 1999 Letter to ICI (there can be differences in valuation depending on fund structures).

370 *See* Duff & Phelps Comment Letter; ICI Comment Letter; KPMG Comment Letter; E&Y Comment Letter; PWC Comment Letter

371 *See* Scheidt Comment Letter 1 (discussing previous SEC enforcement actions regarding odd-lots, including Pacific Investment Management Company LLC, Investment Company Act Release No. 4577 (Dec. 1, 2016) and Semper Capital Management, LP, Investment Advisers Act Release No. 5489 (Apr. 28, 2020)). .

372 *See, e.g.,* ICI Comment Letter.

With respect to the comments concerning odd lot valuation practices, the rescission of the ASRs will not change the Commission's ability to bring similar enforcement cases in the future. The cases were brought under several legal bases, including section 34(b) of the Act and 17 CFR 270.22c-1, because the funds made misstatements related to their performance and sold shares at a price other than their current net asset values. Although the guidance in the ASRs has been cited in prior cases, these cases were brought under independent legal bases as stated above, and valuing odd lots at a price that a fund cannot access on the measurement date will continue to be inconsistent with these requirements and ASC Topic 820 after the rescission of the ASRs.[373]

Among other things, ASC Topic 820 provides a principles-based framework for valuing all investments. The accounting standards are not designed to describe specific fair value measurement fact patterns; we disagree with certain commenters that certain fund specific valuation issues are not addressed in U.S. GAAP and continue to believe that the principles in ASC Topic 820 provide a framework appropriate to utilize for all fair value measurements.[374] In light of this, and in connection with the adoption of rule 2a-5, the specific incremental guidance included in the ASRs is no longer necessary.

Furthermore, as discussed in the proposing release, the guidance in ASR 118 states that auditors of funds should verify all quotations for securities with readily available market quotations, implicating the auditor's requirement to test the valuation assertion for all securities when auditing a fund's financial statements.[375] We believe, and commenters agreed, that rescinding the auditing guidance included in ASR 118 would allow fund auditors to apply only PCAOB standards, which would permit sampling and other techniques to verify the value of a

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373 ASC Topic 820 requires that the reporting entity have access to the principal or most advantageous market used to measure fair value (see ASC 820-10-35-6A), and so a reporting entity may not use round lot pricing if it is not able to access the round lot market at the measurement date.

374 *See* Scheidt Comment Letter 1.

375 *See* Proposing Release, *supra* footnote 2, at n.149

fund's investments, and believe that such a change is appropriate.[376] While this will provide the auditors with greater flexibility in carrying out their audit procedures, a fund board or valuation designee could request that its auditor continue current practice to verify 100% of the values of the fund's investments if it determines that this approach is preferable.[377] Therefore, after review of the comments received and for the reasons noted above, ASR 113 and ASR 118 are rescinded in their entirety upon the compliance date of the final rule.[378]

F. Existing Commission Guidance, Staff No-Action Letters, and Other Staff Guidance

In addition to our rescission of ASR 113 and ASR 118, certain Commission guidance, staff letters and other staff guidance addressing a board's determination of fair value and other matters covered by the rules will be withdrawn or rescinded in connection with this adoption. Upon the compliance date of these rules, some staff letters and other Commission and staff guidance, or portions thereof, will be moot, superseded, or otherwise inconsistent with the rules and, therefore, will be withdrawn or rescinded.

Commenters generally agreed that certain existing Commission and staff guidance should be withdrawn as part of the adoption of rule 2a-5.[379] While many commenters agreed with the scope of the guidance we identified for withdrawal in the proposal, others suggested that additional guidance be withdrawn or rescinded, such as the guidance on overseeing pricing

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376 *See* PWC Comment Letter; KPMG Comment Letter; E&Y Comment Letter; Deloitte Comment Letter; ICI Comment Letter; IDC Comment Letter; NYSSCPA Comment Letter. *See also* Proposing Release, *supra* footnote 2, at n.149, stating that the statutory requirement in section 30(g) of the Investment Company Act, which requires the independent public accountant to verify securities owned, implicates the auditors requirement to test the existence assertion of all securities. The statutory requirement under section 30(g) remains distinct from the rescinded valuation guidance in ASR 118 and the auditing standards established by the PCAOB concerning accounting estimates, including fair value.

377 See ICI Comment Letter.

378 *See infra* footnote 391 and accompanying text (stating that a fund may voluntarily comply with the final rule in advance of the compliance date).

379 *See, e.g.,* ICI Comment Letter; IDC Comment Letter; ABA Comment Letter; MFDF Comment Letter; Capital Group Comment Letter; Invesco Comment Letter.

services contained in the 2014 Money Market Fund Release.[380] As discussed in section II.A.4 above (relating to pricing services), the guidance on oversight of pricing services contained in the 2014 Money Market Fund Release is superseded by the guidance on pricing service oversight contained in this release.[381] Additionally, as discussed in the fair value methodologies section above, we are rescinding and restating certain guidance the Commission provided in the 2014 Money Market Fund Release regarding the valuation of thinly traded securities.[382] As proposed, however, we are not modifying or supplementing the Commission's prior guidance regarding the use of the amortized cost method because the Commission continues to believe that our prior guidance, as discussed in the 2014 Money Market Fund Release, remains relevant, adequate, and appropriate.[383] Finally, two commenters[384] asked that one staff no-action letter be retained regarding the meaning of "good faith," which characterizes "good faith" as "a flexible concept that can accommodate many different considerations."[385] Retaining the staff letters as recommended by these commenters is unnecessary because the framework set out in U.S. GAAP along with the guidance provided in the fair value methodologies section of this release supports this flexible meaning of good faith.[386]

Upon the compliance date of the rules, certain Commission guidance as well as all the staff letters and other staff guidance listed below will be withdrawn. Some commenters also asked that we confirm that, to the extent staff guidance not identified in the proposal conflicts

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380 ABA Comment Letter; MFDF Comment Letter; Fidelity Trustees Comment Letter; IDC Comment Letter; NYC Bar Comment Letter; American Funds Trustees Comment Letter; Council of Institutional Investors Comment Letter.

381 *See supra* section II.A.4.

382 *See supra* section II.A.2.

383 *See supra* footnote 116 (noting that the guidance in the 2014 Money Market Fund Release on the use of amortized cost valuation remains valid).

384 ICI Comment Letter; Federated Hermes Comment Letter. *See also* SIFMA AMG Comment Letter.

385 *See* Investment Company Institute, SEC Staff No-Action Letter (Dec. 8, 1999).

386 *See supra* section II.A.2. For example, under U.S. GAAP, investments generally have a range of acceptable values. Accordingly, different funds, based on the various factors and market conditions considered could reasonably come to different conclusions on the price of a particular investment.

with the requirements of the rules, such guidance is superseded.[387] To the extent any staff guidance is inconsistent or conflicts with the requirements of the rules, even if not specifically identified below, that guidance is superseded.

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 of 1940, Investment Company Act Release No. 15612, Appendix B, Guide 2	Mar. 17, 1987	Fair value for UITs to be determined by the trustee or its appointed person.
Investment Company Institute	Dec. 8, 1999	Fair value generally.
Investment Company Institute	Apr. 30, 2001	Fair value generally.
Last paragraph of Section III.D.2.(a) and the entirety of Section III.D.2.(b) of the 2014 Money Market Fund Release	July 23, 2014	Guidance regarding the fair value of thinly traded securities and use of pricing services.
Valuation Guidance Frequently Asked Questions (FAQ 1 only)	2014	Fund directors' responsibilities when determining whether an evaluated price provided by a pricing service, or some other price, constitutes fair value.

G. Transition Period

The Commission is adopting an eighteen month transition period beginning from the effective date of the rules to provide sufficient time for funds and valuation designees to prepare to come into compliance with rules 2a-5 and 31a-4.[388] Some commenters urged the Commission to provide more time beyond the one-year transition period we discussed in the Proposing Release, suggesting an extended time period of eighteen months for compliance in light of the

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387 ABA Comment Letter.

388 The compliance date will require boards and valuation designees to implement the new rules as of that date regardless of their fiscal year end or financial reporting period.

aspects of the proposed rule that they believed may require funds to change certain of their practices.[389] We appreciate these concerns, and accordingly, the compliance date will be eighteen months following the effective date of the rules. We will rescind ASRs 113 and 118 on the compliance date, and the other identified guidance will also be withdrawn. Additionally, we agree with one commenter that urged the Commission to provide funds with the option of complying with the rules prior to the compliance date.[390] Once the rules become effective, a fund may voluntarily comply with the rules in advance of the compliance date. To promote regulatory consistency, however, any fund that elects to rely on rules 2a-5 and 31a-4 prior to the compliance date may rely only on rules 2a-5 and 31a-4, and not also consider Commission and staff letters and other guidance that will be withdrawn or rescinded on the compliance date in determining fair value in good faith for purposes of section 2(a)(41) of the Act and rule 2a-4 thereunder.[391]

H. Other Matters

Pursuant to the Congressional Review Act,[392] the Office of Information and Regulatory Affairs has designated these rules, collectively, as a "major rule," as defined by 5 U.S.C. 804(2). If any of the provisions of these rules, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

III. ECONOMIC ANALYSIS

A. Introduction

Rule 2a-5 provides requirements for determining fair value in good faith for purposes of section 2(a)(41) of the Act and rule 2a-4 thereunder. The Commission is adopting rule 2a-5 for

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389 *See, e.g.,* ICI Comment Letter; Dechert Comment Letter; IDC Comment Letter; Invesco Comment Letter.

390 *See* ABA Comment Letter.

391 As evidence of the date of early compliance, the records to be kept under rule 2a-5 would also need to begin being maintained as of that date.

392 5 U.S.C. 801 *et seq*.

the reasons provided above in section II. The final rule provides that determination of fair value in good faith requires assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; and evaluating any pricing services used.[393] The Commission is also adopting rule 31a-4, which includes the recordkeeping requirements associated with rule 2a-5.

Rule 2a-5 permits a fund's board of directors to designate certain parties to perform such fair value determinations in good faith, who will then carry out these functions for some or all of the fund's investments. This designation will be subject to board oversight and certain reporting and other requirements designed to facilitate the board's ability to oversee effectively this party's fair value determinations.[394] These requirements of the final rule directly address conflicts of interest and other risks posed when fair value determinations are performed by persons other than the board. It also provides a mechanism for coordinating the requirements of the Act with U.S. accounting standards. Lastly, rule 2a-5 defines when market quotations are readily available for purposes of section 2(a)(41) of the Act.[395]

We are sensitive to the economic effects that may result from the rules, including the benefits, costs, and the effects on efficiency, competition, and capital formation.[396] 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.

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393 *See* rule 2a-5(a). Additionally, upon the adoption of rule 2a-5, rule 38a-1 will require the adoption and implementation of written policies and procedures reasonably designed to prevent violations of the requirements of rule 2a-5.

394 *See* rule 2a-5(b).

395 *See* rule 2a-5(c).

396 Our analysis of the final rule takes into account the rescission of ASR 113 and ASR 118 as well as the withdrawal and rescission of certain staff letters and Commission and staff guidance addressing a board's determination of fair value and other matters covered by rule 2a-5. *See supra* sections II.E and II.F.

We discuss potential effects of the rules as well as possible alternatives to the rules 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 rules. 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 rules, we provide a qualitative assessment of the potential effects.

B. Economic Baseline

1. Current Regulatory Framework

To understand the effects of the rules, we compare the requirements of the rules to the current regulatory framework and current industry practices. As discussed in greater detail in section II 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.[397]

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. Under the Investment Company Act, whenever market quotations are readily available for a security, these market quotations must be used to value that security.[398] Whenever market quotations are not readily available for a fund security or if the investment is not a security, the fund must value that investment using its fair value as determined by the board in good faith.

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397 *See supra* footnotes 1, 2, and 4. *See also supra* section I (discussing other aspects of funds' regulatory framework that are related to boards' fair value role (*e.g.*, ASC Topic 820)).

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

As discussed in the Proposing Release, the Commission stated 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).[399] 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.[400] In addition, the Commission stated that boards should consider all appropriate factors relevant to the fair value of fund investments for which market quotations are not readily available.[401] 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.[402]

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."[403] The 2014 Money Market Fund Release also stated that "evaluated prices provided 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."[404] In addition, the Commission discussed in that release the factors that the fund's board of directors may want to consider "[b]efore deciding to use evaluated prices from a pricing service to assist it in determining the fair values of a fund's portfolio securities."[405]

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399 *See* Proposing Release, *supra* footnote 2, at n.14.

400 *Id*.

401 *See* Proposing Release, *supra* footnote 2, at n.15.

402 *See* Proposing Release, *supra* footnote 2, at n.16; ASR 118.

403 2014 Money Market Fund Release, *supra* footnote 11, at 47813.

404 *Id*. at 47814.

405 *Id.*

Finally, for a fund to engage in a cross trade under rule 17a-7, the security first must have a "readily available market quotation" and then the transaction must meet the other conditions of rule 17a-7. Currently, funds and their affiliates rely on rule 17a-7 and consider related staff no-action letters when engaging in cross trades of certain fixed-income securities. Funds' reliance on rule 17a-7 and funds' practices in consideration of related staff no-action letters form part of our baseline for the economic analysis of the final rules.[406]

2. Current practices

Our understanding of current fair value practices is based on fund disclosures, staff discussions with industry representatives, staff's experience, review of relevant industry publications and academic papers, and commenters' letters.[407] We expect that funds' policies and procedures generally reflect their fair value practices.[408] We discuss below our understanding of current practices but acknowledge that practices may vary across funds and through time.[409]

a) Fair Value Calculation

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406 *See supra* section II.D.

407 *See*, *e.g.*, IDC Role of the Board, *supra* footnote 215; K&L Gates*, Mutual Fund Valuation and Liquidity Procedures* (2013*), available at* https://files.klgates.com/files/upload/dc_im_07-valuation.pdf ("2013 K&L Report"); Arthur Delibert, *Mutual Fund Pricing and Fair Valuation*, K&L Gates 2016 Investment Management Conference; (2016), *available at* https://files.klgates.com/files/upload/2016im_dc_conference_presentations_sessioniv.pdf; Mutual Fund Directors Forum, *Practical Guidance for Fund Directors on Valuation Oversight* (June 2012), *available at* https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/practical-guidance-for-fund-directors-on-valuation-oversight.pdf?sfvrsn=68e27dc6_2 ("MFDF Valuation Report"); *supra* footnote 10 and accompanying discussion. *See also* ABA Comment Letter; Advisors' Inner Circle Comment Letter; AIMA Comment Letter; American Bankers Association Comment Letter; American Funds Comment Letter; Better Markets Comment Letter; Dechert Comment Letter; Duff & Phelps Comment Letter; Fidelity Comment Letter; Fidelity Comment Letter; Fidelity Trustees Comment Letter; Franklin Comment Letter; IAA Comment Letter; ICI Comment Letter; IDC Comment Letter; Invesco Comment Letter; IVSC Comment Letter; MFS Comment Letter; Murphy Comment Letter; New York City Bar Association Comment Letter; SIFMA AMG Comment Letter; TRC Comment Letter; VRC Comment Letter.

408 *See*, *e.g.*, IDC Role of the Board, *supra* footnote 215, at 6-7. *See also* AIMA Comment Letter; Fidelity Trustees Comment Letter; ICI Comment Letter; Invesco Comment Letter; SIFMA AMG Comment Letter.

409 *See supra* footnote 8 and accompanying discussion, and section II; *see also infra* footnotes 407 and 408.

Most fund boards or UIT trustees do not play a day-to-day role in the pricing of fund investments.[410] Typically, an adviser to a fund or other service providers perform the actual day-to-day fair value calculations.[411] Commenters stated that sub-advisers play a role or assist in the fair value determination process.[412] In addition to performing day-to-day calculations, advisers also typically develop (or assist the board in developing) the fund's fair value methodologies.[413] Commenters generally validated this view of boards' oversight role and advisers' roles in day-to-day fair value calculations.[414] We understand that for UITs, which do not have a board of directors or an adviser, it is generally the evaluator designated in the UIT's trust indenture, which is often the UIT's depositor, that conducts the valuation activities equivalent to fund boards.[415] This evaluator may also seek assistance from service providers (such as pricing services) to perform the actual day-to-day fair value calculation. As discussed above,[416] pricing services provide advisers, funds, and depositors with information such as evaluated prices, matrix prices, price opinions, or other information for a wide range of investments, including fixed-income

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410 *See*, *e.g.*, Investment Company Institute, Independent Directors Council, & ICI Mutual Insurance Company, *An Introduction to Fair Valuation* (Spring 2005), at 7, *available at* https://www.icimutual.com/system/files/Fair%20Valuation%20Series%20An%20Introduction%20to%20Fair%20Valuation.pdf ("ICI Fair Valuation Report"). 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 407, at 9.

411 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 4. In addition, officers of internally managed funds may also perform this function in lieu of an adviser. *See* Sullivan Comment Letter; Deloitte Comment Letter; Seward & Kissel Comment Letter; SBIA Comment Letter; Franklin Comment Letter; NYC Bar Comment Letter; Dechert Comment Letter; *see also supra* section II.B.

412 *See, e.g.*, IAA Comment Letter, (stating that "while sub-advisers currently may provide input and support to the primary adviser on pricing and the fair value process, ultimately fund boards rely on the primary adviser, not the sub-adviser, to conduct the day-to-day valuation work.")

413 *See*, *e.g.*, 2013 K&L Report, *supra* footnote 407, at 14; MFDF Valuation Report, *supra* footnote 407, at 11.

414 *See, e.g.*, ABA Comment Letter; Advisors' Inner Circle Comment Letter; AIMA Comment Letter; BNY Mellon Comment Letter; Dechert Comment Letter; Scheidt Comment Letter 2; Fidelity Comment Letter; First Trust Comment Letter; IAA Comment Letter; ICI Comment Letter; Invesco Comment Letter; JPMAM Comment Letter; Murphy Comment Letter; NYC Bar Comment Letter; Seward & Kissel Comment Letter.

415 *See* ICI Comment Letter; Chapman Comment Letter; AAM Comment Letter; First Trust Comment Letter; Hennion & Walsh Comment Letter; Invesco Comment Letter; BNY Mellon Comment Letter.

416 *See supra* section II.A.4 and *infra* section III.B.2.c).

securities (*e.g.*, corporate and municipal bonds), securitized assets, and bank loans, that are used as prices or as inputs to the fair value determination process, as many commenters acknowledged.[417]

b) Fair Value Practices—Assess and Manage Risks[418]

It is our understanding that boards, advisers, and UIT evaluators currently play an important role in identifying and managing valuation risks,[419] and many commenters confirmed this understanding.[420] 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 investments that are not traded on exchanges, reliability of data provided by credit rating agencies, use of internal information provided by portfolio managers to estimate fair values, use of internally developed models to value investments, extensive use of matrix pricing,

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417 *See* ABA Comment Letter; Advisors' Inner Circle Comment Letter; AIMA Comment Letter; American Bankers Association Comment Letter; American Funds Comment Letter; Baillie Gifford Comment Letter; Capital Group Comment Letter; Dechert Comment Letter; Deloitte Comment Letter; Dimensional Comment Letter; Duff & Phelps Comment Letter; Fidelity Comment Letter; Fidelity Trustees Comment Letter; First Trust Comment Letter; Franklin Comment Letter; Guggenheim Comment Letter; Guggenheim Trustees Comment Letter; ICE Data Comment Letter; ICI Comment Letter; IDC Comment Letter; IHS Markit Comment Letter; Invesco Comment Letter; IVSC Comment Letter; JPMAM Comment Letter; John Hancock Comment Letter; MFDF Comment Letter; Murphy Comment Letter; NYC Bar Comment Letter; NYSSCPA Comment Letter; Refinitiv Comment Letter; SSGA Comment Letter; Stradley Comment Letter; Sullivan Comment Letter; TRC Comment Letter; VRC Comment Letter.

418 *See supra* section II.A.1.

419 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 6-8; Paul Kraft et al., *Fair Valuation Pricing Survey, 17th Edition, Executive Summary*, DELOITTE INSIGHTS (2019), at 10, *available at* https://www2.deloitte.com/us/en/insights/industry/financial-services/fair-valuation-pricing-survey.html#:~:text=The%2017th%20annual%20Deloitte%20Fair,use%20of%20technology%2C%20internal%20controls ("Deloitte Survey"). We lack information on how the Deloitte survey sample was constructed or how the survey data was collected, 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 Commission staff's experience and in line with practices as described in prior Commission staff's letters. *See*, *e.g.*, staff letters, *supra* section II.F.

420 *See, e.g.*, ABA Comment Letter; AIMA Comment Letter; American Bankers Association Comment Letter; American Fund Trustees Comment Letter; Baillie Gifford Comment Letter; CFA Institute Comment Letter; Duff & Phelps Comment Letter; Fidelity Comment Letter; Fidelity Trustees Comment Letter; Guggenheim Comment Letter; Harvest Comment Letter; IHS Markit Comment Letter; Invesco Comment Letter; IVSC Comment Letter; JPMAM Comment Letter; John Hancock Comment Letter; MFDF Comment Letter; Murphy Comment Letter; NYC Bar Comment Letter; Stradley Comment Letter; Sullivan Comment Letter; Vanguard Comment Letter; VRC Comment Letter.

the process surrounding the adviser's price overrides, timely identification of material events, and valuation risks arising from new investments.[421]

Many of these risks are operational in nature, such as model risk, which includes the risk of loss caused by using inaccurate models (methodologies) to make decisions such as determinations of fair value.[422] To the extent that valuation is less informed by liquid markets and price discovery mechanisms and is more informed by models, the risk of biased valuations rises. Model risk includes misspecified models, biased information provided by those with conflicts of interest, use of inappropriate inputs and assumptions, and incorrect implementation.

Funds' valuation practices generally focus on mitigating potential conflicts of interest of the adviser as well as conflicts of interest of other parties that assist the board with fair value determinations (*e.g.*, portfolio managers).[423] Some advisers currently have in place processes to address potential conflicts of interest when portfolio management personnel provides input regarding valuation for a fund.[424] UIT depositors may have weaker conflicts of interest in valuation processes because such depositors are generally compensated based on the number of units, rather than the trust's net assets.[425]

Valuation risks can change with changes in market conditions, changes in fund investments, changes in inputs and assumptions, and changes in methodologies or models.

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421 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 6-8.

422 *See, e.g.*, Clifford Rossi, *How to Reduce Model Risks: 4 Basic Principles*, GLOB. ASS'N OF RISK PROF'L; https://www.garp.org/#!/risk-intelligence/all/all/a1Z1W000003PzmhUAC; SR 11-7: Guidance on Model Risk Management, BD. OF GOVERNORS OF THE FED. RESERVE SYS., https://www.federalreserve.gov/supervisionreg/srletters/sr1107.htm; and Model Risk Management Guidance, FED. HOUSING FIN. AGENCY, https://www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/Pages/AB-2013-07-Model-Risk-Management-Guidance.aspx.

423 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 419, at 10. The cited statistic does not imply that the remaining funds do not have policies in place to manage conflicts of interest of advisers but it means that any such policies may not be valuation specific.

424 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 9.

425 *See, e.g.*, Chapman Comment Letter; ICI Comment Letter.

Hence, funds may periodically review any previously identified valuation risks.[426] 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 investments as part of the assessment and management of previously identified risks.[427]

Many commenters noted that assessing and managing valuation risks is a part of current practice,[428] with one commenter noting the necessity of considering valuation risk in the context of determining whether a given fair value methodology would be appropriate.[429]

c) Fair Value Practices—Establish Fair Value Methodologies[430]

Funds with investments that are fair valued currently have in place written policies and procedures that describe the methodologies used when calculating fair values.[431] Commenters confirmed our understanding of this practice.[432] UITs may provide for the methodology in which the assets shall be valued by the evaluator within the UIT's trust indenture.[433]

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426 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 8.

427 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 419, at 10.

428 *See supra* section II.A.1 and section III.B.2.b).

429 *See* Vanguard Comment Letter.

430 *See supra* section II.A.2.

431 *See*, *e.g.*, IDC Role of the Board, *supra* footnote 215, at 6-7; MFDF Valuation Report, *supra* footnote 407, at 5; rule 38a-1.

432 *See, e.g.*, ABA Comment Letter; Advisors' Inner Circle Comment Letter; AIMA Comment Letter; Capital Group Comment Letter; Chapman Comment Letter; Dechert Comment Letter; Dimensional Comment Letter; Duff & Phelps Comment Letter; First Trust Comment Letter; Franklin Comment Letter; Guggenheim Comment Letter; Guggenheim Trustees Comment Letter; Harvest Comment Letter; IAA Comment Letter; ICE Data Comment Letter; ICI Comment Letter; IDC Comment Letter; IHS Markit Comment Letter; Invesco Comment Letter; University of Miami Comment Letter; IVSC Comment Letter; JPMAM Comment Letter; John Hancock Comment Letter; Murphy Comment Letter; NYC Bar Comment Letter; Refinitiv Comment Letter; Russell Investments Comment Letter; Scheidt Comment Letter 2; SSGA Comment Letter; Stradley Comment Letter; Sullivan Comment Letter; VRC Comment Letter.

433 *See* ICI Comment Letter; Chapman Comment Letter; AAM Comment Letter; First Trust Comment Letter; Hennion & Walsh Comment Letter; Invesco Comment Letter; BNY Mellon Comment Letter.

The methodologies provided in policies and procedures or trust indentures can require multiple data sources and entail various assumptions.[434] Methodologies often establish a suggested ranking of the pricing sources that an adviser should use when valuing investments, and different rankings can be established for different types of investments.[435] Many funds and advisers periodically review the appropriateness and accuracy of the methodologies used in valuing investments and make any necessary adjustments.[436] Further, funds and advisers generally monitor the circumstances that may necessitate the use of fair values.[437] 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.[438] As discussed above, pricing services also play an important role in the fair value determination process and, as such, help to establish fair value methodologies that are reviewed by funds and advisers.[439]

We understand that fund boards, advisers, and UIT depositors and evaluators have generally established fair value methodologies for their investments that lack readily available market quotations, which are generally applied consistently in accordance with policies and procedures or trust indentures as described above.[440] Similarly, many commenters stated that

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434 *See, e.g.*, AIMA Comment Letter; ASA Comment Letter; CFA Institute Comment Letter; Dechert Comment Letter; Duff & Phelps Comment Letter; Harvest Comment Letter; ICI Comment Letter; Invesco Comment Letter; MFS Comment Letter; Murphy Comment Letter; NYC Bar Comment Letter; SIFMA AMG Comment Letter; Chapman Comment Letter.

435 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 5.

436 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 419, at 9 and 14.

437 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 5.

438 *See*, *e.g.*, IDC Role of the Board, *supra* footnote 215, at 6-7 and 10-11; MFDF Valuation Report, *supra* footnote 407, at 5.

439 *See supra* section II.A.4.

440 *See, e.g.*, AAM Comment Letter; BNY Mellon Comment Letter; Chapman Comment Letter; First Trust Comment Letter; Hennion & Walsh Comment Letter; ICI Comment Letter; Invesco Comment Letter.

pricing services establish their own methodologies,[441] subject to the due diligence of the board or adviser,[442] and one commenter stated that pricing services recommend methodologies.[443]

d) Fair Value Practices—Test Fair Value Methodologies[444]

We understand that funds or pricing services generally test the appropriateness and accuracy of internally selected methodologies used to value investments.[445] Funds may utilize methods such as back-testing to review the appropriateness and accuracy of the methodologies used.[446] We understand that many funds use systems to identify security valuations that may require additional attention, such as security prices that have not changed over a period of time and price changes beyond a certain threshold.[447] Many commenters confirmed our understanding that testing fair value methodologies is common practice.[448]

e) Fair Value Practices—Identify Responsibilities

As discussed above, a fund's adviser often plays an important and valuable role in carrying out the day-to-day work of determining fair values, while the board reviews periodic reports from the adviser regarding the fair value of fund investments and fair value practices

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441 *See, e.g.*, ABA Comment Letter; American Bankers Association Comment Letter; Dechert Comment Letter; Dimensional Comment Letter; Guggenheim Comment Letter; IAA Comment Letter; ICE Data Comment Letter; ICI Comment Letter; IDC Comment Letter; John Hancock Comment Letter; Refinitiv Comment Letter; Russell Investments Comment Letter; SSGA Comment Letter; Sullivan Comment Letter.

442 *See, e.g.*, ABA Comment Letter; Dechert Comment Letter; IAA Comment Letter; ICE Data Comment Letter; IDC Comment Letter; John Hancock Comment Letter; Russell Investments Comment Letter; SSGA Comment Letter;

443 *See* NYC Bar Comment Letter.

444 *See supra* section II.A.3.

445 *See infra* section III.B.2.f).

446 *See, e.g.*, ICI Fair Valuation Report, *supra* footnote 410, at 17-18.

447 *See*, *e.g.*, IDC Role of the Board, *supra* footnote 215, at 6-7.

448 *See, e.g.*, ABA Comment Letter; Advisors' Inner Circle Comment Letter; AIMA Comment Letter; American Funds Comment Letter; Capital Group Comment Letter; Dimensional Comment Letter; Duff & Phelps Comment Letter; Fidelity Comment Letter; Franklin Comment Letter; Guggenheim Comment Letter; Harvest Comment Letter; ICI Comment Letter; IHS Markit Comment Letter; Invesco Comment Letter; University of Miami Comment Letter; JPMAM Comment Letter; John Hancock Comment Letter; MFDF Comment Letter; Murphy Comment Letter; NYC Bar Comment Letter; NYSSCPA Comment Letter; Refinitiv Comment Letter; Stradley Comment Letter; Sullivan Comment Letter; TRC Comment Letter.

(*e.g.*, methodologies, testing, etc.).[449] UITs, which lack a board of directors, generally describe who is responsible for valuation duties in the UIT's trust indenture, with the depositor or evaluator generally performing fair value determinations, sometimes with the assistance of other parties such as evaluators.[450] As discussed above[451] and as acknowledged by many commenters,[452] pricing services provide advisers and funds with information such as evaluated prices, matrix prices, price opinions, or other information that is used as prices or as inputs to the fair value determination process. Some boards create separate valuation committees with clearly established functions that help the board provide oversight of the advisers' valuation practices.[453] 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 adviser personnel or board members should be notified when fair value issues arise that are not addressed in existing fair value policies and procedures.[454]

The commenters who weighed in on this aspect confirmed our understanding of these practices.[455] Commenters stated that advisers currently have the "means to ensure that portfolio managers do not exert undue influence on the fair value process"[456] and that other practices such

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449 *See supra* section II.B and section II.B.3.

450 *See supra* section II.B, footnotes 171-173 and accompanying discussion. *See also* AAM Comment Letter; BNY Mellon Comment Letter; Chapman Comment Letter; First Trust Comment Letter; Hennion & Walsh Comment Letter; Invesco Comment Letter; MFS Comment Letter; Seward & Kissel Comment Letter.

451 *See supra* section II.A.4, section III.B.2.a), and section III.B.2.c).

452 *See* ABA Comment Letter; Advisors' Inner Circle Comment Letter; AIMA Comment Letter; American Bankers Association Comment Letter; American Funds Comment Letter; Baillie Gifford Comment Letter; Capital Group Comment Letter; Dechert Comment Letter; Deloitte Comment Letter; Dimensional Comment Letter; Duff & Phelps Comment Letter; Fidelity Comment Letter; Fidelity Trustees Comment Letter; First Trust Comment Letter; Franklin Comment Letter; Guggenheim Comment Letter; Guggenheim Trustees Comment Letter; ICE Data Comment Letter; ICI Comment Letter; IDC Comment Letter; IHS Markit Comment Letter; Invesco Comment Letter; IVSC Comment Letter; JPMAM Comment Letter; John Hancock Comment Letter; MFDF Comment Letter; Murphy Comment Letter; NYC Bar Comment Letter; NYSSCPA Comment Letter; Refinitiv Comment Letter; SSGA Comment Letter; Stradley Comment Letter; Sullivan Comment Letter; TRC Comment Letter VRC Comment Letter.

453 *See*, *e.g.*, IDC Role of the Board, *supra* footnote 215, at 8-10.

454 *Id.* at 7.

455 *See, e.g.*, AIMA Comment Letter; ABA Comment Letter; Murphy Comment Letter; MFS Comment Letter.

456 ICI Commenter Letter; *see also* Seward & Kissel Comment Letter;

as "establish[ing] [a] 'middle office' that facilitates the establishment of [fair value]" determinations mitigates "undue influence" from portfolio managers.[457] Another commenter described segregating duties by "delegating the calculation, determination, and production of the NAV to a suitably independent, competent and experienced third-party valuation service provider" and that "[i]f the investment manager is responsible for determining the NAV, and/or acts as the fund governing body, robust controls over conflicts of interest should be established."[458] The same commenter also described appointing an investment manager valuation committee to mitigate conflicts of interest and ensuring that a broker or dealer that provides inputs to fair value "is free of relationships with the fund through which the investment manager can directly or indirectly control or influence the broker or dealer."[459] Other commenters underscored the importance of segregating duties and described practices to mitigate the risk from conflicts of interest in the valuation process.[460]

f) Fair Value Practices—Evaluate Pricing Services[461]

We understand that, under existing practice, fund boards, advisers, and UIT depositors frequently use third-party pricing service providers to assist in determining fair values.[462] Before engaging 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.[463] Boards may develop an understanding of the circumstances in which third-party pricing services would

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457 *See* VRC Comment Letter.

458 *See* AIMA Comment Letter.

459 *Id.*

460 *See, e.g.*, ABA Comment Letter; Fidelity Comment Letter; IVSC Comment Letter; Murphy Comment Letter.

461 *See supra* section II.A.4.

462 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 10; IDC Role of the Board, *supra* footnote 215, at 10-11.

463 *See*, *e.g.*, IDC Role of the Board, *supra* footnote 215, at 11.

provide assistance in the valuation of fund investments.[464] 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 adviser performed adequate due diligence when selecting the service.[465] 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 the pricing service's presentations to the board, the 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 investments and maintains an adequate control environment.[466] Further, boards may seek to understand the circumstances under which the adviser may challenge or override the prices obtained from the pricing service provider.[467] Many commenters confirmed our understanding of common practices in the evaluation of pricing services.[468] While some commenters stated that some advisers (*e.g.*, small advisers) lack the resources or staffing to perform due diligence of pricing services, back-testing of methodologies, analysis of pricing

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464 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 10.

465 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 11.

466 *Id.*

467 *Id.* at 10-11.

468 *See, e.g.*, ABA Comment Letter; Advisors' Inner Circle Comment Letter; AIMA Comment Letter; Capital Group Comment Letter; Dechert Comment Letter; Deloitte Comment Letter; Dimensional Comment Letter; Duff & Phelps Comment Letter; Fidelity Comment Letter; Fidelity Trustees Comment Letter; First Trust Comment Letter; Guggenheim Comment Letter; Harvest Comment Letter; ICE Data Comment Letter; ICI Comment Letter; IDC Comment Letter; IHS Markit Comment Letter; Invesco Comment Letter; University of Miami Comment Letter; IVSC Comment Letter; JPMAM Comment Letter; John Hancock Comment Letter; KPMG Comment Letter; MFDF Comment Letter; Murphy Comment Letter; NYC Bar Comment Letter; Practus Comment Letter; Refinitiv Comment Letter; Stradley Comment Letter; Sullivan Comment Letter; TRC Comment Letter; Vanguard Comment Letter; VRC Comment Letter.

challenge efficacy, and back-testing of fair value determinations,[469] most commenters stated that funds routinely rely on advisers to conduct due diligence on pricing services.[470]

g) Board Reporting[471]

Many commenters confirmed our understanding of current practices of board reporting.[472] On a periodic basis, as part of their current fair value oversight, boards may review reports from the adviser regarding the fair value of fund investments[473] and fair value methodologies, but rely on the adviser for the day-to-day calculation of fair values.[474] Many boards review fair value determinations based on information provided in quarterly reports, but some boards review the determinations in more or less frequent reporting depending on the type of fund investments and the market conditions.[475] Boards also may have ad-hoc discussions on valuation matters outside of their regular meetings.[476] In some circumstances, board members may play an active role in shaping the type of information contained in and the format of valuation reports given to the board.[477] The content of reports boards receive depends on the type of fund and fund investments.[478] The type of general information that boards may receive

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469 *See, e.g.*, MFS Comment Letter; Sullivan Comment Letter.

470 *See, e.g.*, ABA Comment Letter; Advisors' Inner Circle Comment Letter; American Funds Comment Letter; Capital Group Comment Letter; Dimensional Comment Letter; First Trust Comment Letter; Guggenheim Comment Letter; ICE Data Comment Letter; ICI Comment Letter; IDC Comment Letter; Invesco Comment Letter; John Hancock Comment Letter; Refinitiv Comment Letter; Russell Investments Comment Letter; TRC Comment Letter.

471 *See supra* section II.B.1.

472 *See, e.g.*, ABA Comment Letter; Advisors' Inner Circle Comment Letter; AIMA Comment Letter; American Funds Comment Letter; Capital Group Comment Letter; Dechert Comment Letter; Fidelity Comment Letter; Fidelity Trustees Comment Letter; Guggenheim Comment Letter; IAA Comment Letter; IDC Comment Letter; MFS Comment Letter; Murphy Comment Letter; SIFMA AMG Comment Letter; Vanguard Comment Letter.

473 *See*, *e.g.*, IDC Role of the Board, *supra* footnote 215, at 12-13.

474 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 2 as well as *supra* section III.B.2.e).

475 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 10. *See also* Deloitte Survey, *supra* footnote 419, 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).

476 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 14.

477 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 14.

478 *Id*.

includes a summary of back-testing data and an analysis of the impact of fair values on the fund's NAV.[479] The reports also may include more specific information about fund investments that are more difficult to value, such as the fair values assigned to each investment, 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.[480] Some board reports may also include security-specific information in cases where advisers override prices provided by pricing services.[481] 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.[482]

Valuation reports may vary depending on the volume and complexity of fair value determinations.[483] 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 sample report on an asset that was assigned a fair value to illustrate the methodology that is used by the adviser.[484]

h) Recordkeeping[485]

It is our understanding that funds and advisers currently retain records related to fair value determinations. These records generally include identifying information for each portfolio investment, data used for pricing, and any other information related to price determinations and fund valuation policies and procedures. Commenters generally confirmed our understanding of common practices in recordkeeping.[486] We recognize that some fund boards may not apply these

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479 *See*, *e.g.*, IDC Role of the Board, *supra* footnote 215, at 12.

480 *Id.* at 12-13.

481 *Id.* at 13. *See also* Deloitte Survey, *supra* footnote 419, 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).

482 *See*, *e.g.*, IDC Role of the Board, *supra* footnote 215, at 13.

483 *See*, *e.g.*, MFDF Valuation Report, *supra* footnote 407, at 14.

484 *Id*.

485 *See supra* section II.C.

486 *See, e.g.*, Advisors' Inner Circle Comment Letter; AIMA Comment Letter; Baillie Gifford Comment Letter; Duff & Phelps Comment Letter; Fidelity Comment Letter; Franklin Comment Letter; Guggenheim Comment Letter; Guggenheim Trustees Comment Letter; ICE Data Comment Letter; ICI Comment Letter;

same recordkeeping practices for some investments, including, for example, those for which the board relies on pricing services for fund investments using level 2 inputs for fair value determinations.[487] Furthermore, commenters described common recordkeeping practices such as maintaining specific methodologies, inputs, and assumptions for investments fair valued with level 3 inputs and conducting due diligence of pricing services' methodologies and testing for investments fair valued with level 2 inputs;[488] maintaining records of methodologies and other detailed inputs and assumptions for cases when a fund, board, or adviser establishes and applies its own methodologies;[489] maintaining only prices from a pricing service (*e.g.*, evaluated prices for securities fair valued with level 2 inputs) that were actually used as an input by the adviser;[490] and not maintaining records for investments for which the funds rely on pricing services to calculate fair value for assets valued with level 2 inputs.[491]

i) Cross Trades[492]

It is our understanding that some funds currently rely on rule 17a-7 and consider staff no-action letters when engaging in cross trades in investments, including fixed-income securities.[493] Commenters confirmed our understanding of the common practice of cross trades.[494]

IDC Comment Letter; Invesco Comment Letter; University of Miami Comment Letter; JPMAM Comment Letter; John Hancock Comment Letter; MFS Comment Letter; NYC Bar Comment Letter; SIFMA AMG Comment Letter; SSGA Comment Letter; Stradley Comment Letter; Sullivan Comment Letter; TRC Comment Letter; Vanguard Comment Letter; VRC Comment Letter.

487 *See, e.g.,* American Bankers Association Comment Letter; Baillie Gifford Comment Letter; Capital Group Comment Letter; ICE Data Comment Letter; John Hancock Comment Letter; SSGA Comment Letter; TRC Comment Letter; Vanguard Comment Letter.

488 *See, e.g.*, Vanguard Comment Letter.

489 *See, e.g.*, IDC Comment Letter.

490 *See, e.g.*, SSGA Comment Letter.

491 *See, e.g.*, Franklin Comment Letter; Baillie Gifford Comment Letter.

492 *See supra* section II.C.

493 *See supra* footnotes 356, 357, and 358 and accompanying discussion.

494 *See, e.g.*, ABA Comment Letter; Capital Group Comment Letter; Dechert Comment Letter; Dimensional Comment Letter; ICE Data Comment Letter; ICI Comment Letter; Murphy Comment Letter; NYC Bar Comment Letter; Stradley Comment Letter; Sullivan Comment Letter; TRC Comment Letter.

Furthermore, some commenters noted that some funds may currently cross trade certain assets that rely on level 2 inputs.[495]

3. Affected parties

Rules 2a-5 and 31a-4 potentially affect all registered investment companies and BDCs (because their fund investments must be fair valued under the Act), those funds' boards of directors, advisers, and investors. The rules also affect funds that engage in cross trades. Table 1 below presents descriptive statistics for the funds that could be affected by the rules. As of September 11, 2020, there were 14,010 registered investment companies: (i) 12,680 open-end funds; (ii) 664 closed-end funds; (iii) 661 UITs; and (iv) 14 variable annuity separate accounts registered as management companies.[496] As of the same date, (i) open-end funds held total net assets of $27,112 billion; (ii) closed-end funds held total net assets of $308 billion; (iii) UITs held total net assets of $2,113 billion; and (iv) variable annuity separate accounts registered as management companies held total net assets of $226 billion. As of September 2020, there were 97 BDCs with $62 billion in total net assets.[497] Not all funds hold investments that must be fair valued under the Act, and not all funds engage in cross trades. In addition, for those funds that hold investments that must be fair valued under the Act or that engage in cross trades, the extent of those investments and activities varies. Hence, the rules affect only a subset of the funds listed in Table 1 below.

Table 1: Descriptive statistics for funds

	Number of funds (1)	Total Net Assets (in billion $) (2)

[495] *See supra* section II.D.

[496] We estimate the number of registered investment companies by reviewing the most recent filings of Forms N-CEN filed with the Commission as of September 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.

[497] 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 2020, 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 eight wholly owned subsidiaries of other BDCs and feeder BDCs in master-feeder structures.

Open-end funds	12,680	27,112
Closed-end funds	664	308
UITs	661	2,113
Management company separate accounts	14	226
BDCs[1]	97	62
Total	14,116	29,821

Note 1. Out of 97 BDCs reporting on Form N-CEN, nine were reported as being internally managed.
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 rules could affect funds' operations (including for funds that engage in cross trades), we examine funds' investments under the U.S. GAAP fair value hierarchy.[498] For purposes of this economic analysis, we treat investments that are valued using level 1 inputs as investments for which readily available market quotations are available, and investments valued using level 2 and 3 inputs as investments that must be fair valued in good faith under the Act's definition of value.[499] We therefore expect that funds that hold more investments that are valued using level 2 and level 3 inputs will be more affected by the rules than funds with no or fewer such investments. In particular, as commenters noted, some funds currently treat some investments valued with level 2 inputs as having readily available market quotations and perform determinations of fair value in good faith on other investments valued with level 2 inputs.[500]

Table 2 provides descriptive statistics on funds' investments measured based on level 1, 2, and 3 inputs using Form N-PORT data as of September 2020.[501] As Table 2 shows, there are

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498 According to ASC Topic 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* ASC Topic 820, *supra* footnote 1.

499 *See* rule 2a-5(c). *See also supra* section II.D.

500 *See, e.g.*, Capital Group Comment Letter; IAA Comment Letter.

501 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 September 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

13,101 funds with $24,417 billion in net assets that filed Form N-PORT.[502] About 62% of fund assets are valued using level 1 inputs. Nevertheless, the average percentage of investments valued using level 1 inputs varies depending on the type of fund, ranging from 26% for closed-end funds to 99% for ETFs registered as UITs. About 34% of fund assets are valued using level 2 inputs, which also varies depending on the type of fund. Only a small percentage of fund assets are valued using level 3 inputs.[503]

Table 2: Descriptive statistics for funds by ASC Topic 820 fair value hierarchy[1]

	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	12,387	23,475	62%	35%	0.2%	1%
Registered closed-end funds	696	305	26%	53%	6%	12%
ETFs registered as UITs	5	423	99%	0%	0%	0%
Management company separate accounts	13	212	75%	26%	0%	0%
Total / Average	13,101	24,415	62%	34%	0%	1%

Note 1: Out of the 12,387 open-end funds, two reported being internally managed with net assets of $7 billion. Out of the 696 registered closed-end funds, 12 reported being internally managed with net assets of $18 billion. No ETFs registered as UITs or management company separate accounts reported being internally managed. Approximately 19.5% of assets of open-end funds were foreign holdings; less than 1% of assets of closed-end funds, ETFs registered as UITs, and management company separate accounts were foreign holdings.

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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.

502 The numbers of open-end funds, closed-end funds, and separate accounts registered as management companies that filed Form N-PORT reported in Table 2 differ from those that filed Form N-CEN reported in Table 1 due to differing reporting requirements and the frequency of reporting. Total net assets in Form N-CEN also may be different from 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.

503 Investments 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 investments arguably requires less effort than the valuation of investments valued using level 2 and 3 inputs because funds' NAVs are easily obtainable. About 1% of the fund assets are classified as "N/A" investments. For open-end funds, approximately 1% of "N/A" investments are classified as private fund investments and approximately 85% are classified as registered fund investments; for closed-end funds, approximately 68% are classified as private fund investments and approximately 23% are classified as registered fund investments. The sum of the average using level 1, 2, 3, and "N/A" within each fund category may not sum up to 100% due to rounding error.

Source: Form N-PORT

As of September 2020, there were 1,518 advisers that reported providing portfolio management for investment companies or BDCs with regulatory assets under management of $61.6 trillion, of which $33.6 trillion was attributable to investment company and BDC clients.[504] Among the open-end funds reported in Table 2, approximately 2% reported not engaging a pricing service. Among the closed-end funds reported in Table 2, approximately 12% reported not engaging a pricing service. No ETF registered as a UIT reported engaging a pricing service, and all management company separate accounts reported engaging a pricing service. As of December 2019, there were 59.7 million U.S. households and 103.9 million individuals owning U.S. registered investment companies that could be affected by the rules.[505] Untabulated analysis shows that 29% of the funds report having 100% of their investments valued using level 1 inputs.[506] Based on this, we estimate that approximately 9,804 funds may be affected by the rules, of which 9,335 are not UITs.[507] However, foreign holdings made up approximately (1) 20% of assets of open-end funds; (2) 24% of assets of closed-end funds; (3) 23% of assets of ETFs registered as UITs; and (4) 3% of assets of management company separate accounts. Overall, approximately 20% of assets were foreign holdings. Thus, to the extent that funds

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504 Based on Form ADV Items 5.G.(3), 5.F.2.(c), 5.D.(d)(3), and 5.D.(e)(3) of Part 1A of Forms ADV filed with the Commission as of September 2020.

505 Investment Company Institute, *Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry*, 60th Edition (2020), *available at* https://www.ici.org/pdf/2020_factbook.pdf, (last accessed on Sept. 4, 2020).

506 29% = (3,810 open-end funds with investments valued using only level 1 inputs that filed Form N-PORT + 45 closed-end funds with investments valued using only level 1 inputs that filed Form N-PORT + 5 ETFs registered as UITs with investments valued using only level 1 inputs that filed Form N-PORT + 3 variable annuity separate accounts registered as management companies with investments valued using only level 1 inputs that filed Form N-PORT) / 13,101 funds that filed Form N-PORT. *See supra* footnote 502.

507 9,804 funds = 13,101 funds that filed Form N-PORT from Table 2 – 3,863 funds that hold investments valued using only level 1 inputs and filed Form N-PORT + 97 BDCs from Table 1 above + 469 affected UITs. 469 = 661 UITs that filed Form N-CEN * (1 – 29% of funds that only report securities valued using level 1 inputs based on N-PORT data). This calculation assumes that the distribution of investments valued using level 1 inputs for registered investment companies that filed Form N-PORT is similar to the distribution of investments valued using level 1 inputs for UITs that filed Form N-CEN. This calculation also assumes that all 97 BDCs in our sample hold a non-zero amount of investments valued using level 2 and level 3 inputs. This assumption is made 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).

determined that these foreign holdings had readily available market quotations (*i.e.*, are reported falling in level 1 in the fair value hierarchy), the 29% estimate of funds unaffected by the rules may be overstated. Furthermore, approximately 28% of funds reported relying on 17a-7 for cross trades, but we cannot determine to what extent reliance on 17a-7 is limited to investments meeting the definition under the final rule of having readily available market quotations.

C. General Economic Considerations

1. Investment Adviser Role in Fair Value Determinations

Unbiased valuation of fund investments is important because it affects the prices at which fund shares are purchased or redeemed by shareholders. Similarly, to the extent that valuation reflects what would be obtained in a current arm's length transaction, such valuation could also provide fund managers and investors a more accurate picture of the funds' volatility.[508] This could help fund managers better tailor their portfolios to specific risk-reward profiles or benchmarks and ensure that their portfolios comply with the fund's risk appetite statement. Likewise, investors could better evaluate how a given fund fits their risk appetite and ability to bear risk. Valuation of fund investments 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.[509]

As explained above, we understand that boards typically rely on fund advisers to perform the day-to-day calculation of fair value determinations for fund investments that do not have readily available market quotations.[510] Because a board's role is focused on oversight rather than day-to-day involvement in fund activities such as valuation, this is appropriate to ensure that

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508 *See* Comment Letter of Will Gornall and Ilya Strebulaev (May 19, 2020) (describing the difficulty of valuation and consequences of low quality valuations, including mismeasurement of risk and returns, which in turn leads to overly smoothed valuations, inflated risk-adjusted performance measures, misallocation of capital, and, ultimately, economic inefficiency).

509 *See supra* section II for more discussion on the importance of unbiased valuation of fund investments.

510 *See supra* section II.B.1 and footnote 201 as well as section III.B.2.

boards are not engaging in duties that distract them from oversight and governance of the fund and its fair value process. Furthermore, a board's members are unlikely to have the necessary experience, knowledge, skills, or resources to carry out the day-to-day calculation of fair value determination.

Fund advisers' interests may conflict with the interest of shareholders,[511] an issue that many commenters echoed.[512] In particular, advisers have incentives to inflate fund asset values (or deflate fund liability values) because they typically receive a management fee that is calculated as a percentage of the value of net assets under management.[513] Relatedly, advisers have incentives to inflate fund asset values because investors tend to invest more in funds with good recent performance, which would increase assets under management and ultimately

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511 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, Aug. 2019), *available at* https://ssrn.com/abstract=3066449; Rahul Bhargava, Ann Bose, & David A. Dubofsky, *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, Nov. 2019), available at https://www.wu.ac.at/fileadmin/wu/d/i/finance/BBS-Papers/SS2019/20190515_STOUGHTON.pdf; John M. R. Chalmers, Roger M. Edelen, & Gregory B. Kadlec, *On the Perils of Financial 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, Mathias Kronlund, & Ji Yeol Jimmy Oh, *Sitting Bucks: Zero Returns in Fixed Income Funds* (Working Paper, Aug. 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244862; Gjergji Cici, Scott Gibson, & John J. Merrick Jr., *Missing the marks? Dispersion in corporate bond valuations across mutual funds*, 101 J. FIN. ECON. 206 (2011) ("Cici et al. 2011"); Vladimir Atanasov, John J. Merrick Jr., & Philipp Schuster, *Mismarking Fraud in Mutual Funds* (Working Paper, Apr. 2019), *available at* http://www.fmaconferences.org/Glasgow/Papers/Fraud_in_OpenEndMutualFunds_2018_1126.pdf. As noted above, officers of internally managed funds that perform these functions in lieu of an adviser may face conflicts that are different from those of advisers. *See supra* footnote 159.

512 *See, e.g.*, AAM Comment Letter; ABA Comment Letter; AIMA Comment Letter; American Bankers Association Comment Letter; American Funds Trustees Comment Letter; Better Markets Comment Letter; BlackRock Trustees Comment Letter; CFA Institute Comment Letter; Chapman Comment Letter; Dechert Comment Letter; Duff & Phelps Comment Letter; Fidelity Comment Letter; Fidelity Trustees Comment Letter; First Trust Comment Letter; Franklin Comment Letter; Guggenheim Comment Letter; Hennion & Walsh Comment Letter; ICE Data Comment Letter; IDC Comment Letter; IHS Markit Comment Letter; University of Miami Comment Letter; IVSC Comment Letter; John Hancock Comment Letter; MFS Comment Letter; Murphy Comment Letter; NYC Bar Comment Letter; Scheidt Comment Letter 2; Seward & Kissel Comment Letter; SIFMA AMG Comment Letter; TRC Comment Letter; VRC Comment Letter.

513 *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 advisers' compensation to fund size, there may be implicit contracts that provide incentives to advisers to mismeasure fund investments. For example, advisers may mismeasure fund investments to meet or beat certain benchmarks. *See*, *e.g.*, Chandar and Bricker 2002.

increase advisers' compensation.[514] Advisers also have incentives to mismeasure fund investments in a way that would smooth reported fund performance over time to lower the funds' perceived risk.[515] Finally, advisers may mismeasure values of fund investments as a result of expending less effort than the effort required to ensure more accurate and unbiased valuations.[516] Any such mismeasurement likely will be more pronounced for investors of funds whose shares are not publicly traded (*e.g.*, open-end funds (other than ETFs), UITs, and some BDCs) because there is no secondary market for the shares of those funds, and fund investors can transact only at a price based on NAV, which is determined by the fund's fair value determinations.

The degree of such conflicts of interest may vary across funds,[517] depending on the extent to which funds or their advisers rely on pricing services for fair value determinations,[518] the types of assets being subjected to fair value determinations[519] (*e.g.*, there may be a tension between expertise that an adviser may provide for particularly complex assets or alternative investments and the consequent lack of independence), and the manner in which an adviser or depositor is

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514 *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. 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, Yuehua Tang, & Juan-Pedro Gomez, *Portfolio Manager Compensation in the U.S. Mutual Fund Industry*, 74 J. FIN. 587 (2018).

515 *See*, *e.g.*, Cici et al. 2011.

516 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 Active Asset Management*, 125 J. FIN. ECON. 311 (2017) ("Brown and Davies 2017").

517 *See, e.g.*, AAM Comment Letter; Chapman Comment Letter; First Trust Comment Letter; Hennion & Walsh Comment Letter on the notion that UITs pose a lower level of concern in regard to such conflicts of interest.

518 Pricing services may mitigate conflicts of interest by, for example, contributing to a clearer segregation between fair value determinations and portfolio management. On the other hand, pricing services also may be incentivized to provide higher or more aggressive valuations generally to retain business. *See, also, e.g.*, AIMA Comment Letter; American Bankers Association Comment Letter; Dechert Comment Letter; Fidelity Trustees Comment Letter; Guggenheim Comment Letter; ICE Data Comment Letter; IHS Markit Comment Letter; John Hancock Comment Letter; Murphy Comment Letter; VRC Comment Letter.

519 *See, e.g.*, AIMA Comment Letter; American Bankers Association Comment Letter; American Funds Comment Letter; Fidelity Comment Letter; Guggenheim Comment Letter; SIFMA AMG Comment Letter; TRC Comment Letter.

compensated. In particular, 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, advisers' incentives to underinvest in effort may be higher for funds whose performance is more difficult to measure and evaluate, and thus advisers' performance is also more difficult to measure and evaluate (*e.g.*, funds that hold complex investments).[520] Conflicts of interest may be lower for parties whose compensation is not based on the value of assets, as is the case with depositors or evaluators of some UITs. Officers of internally managed funds who make determinations of fair value may also be subject to conflicts of interest to the extent that their compensation is related to the value of assets. Boards of directors currently serve as a check on the conflicts of interest of the adviser, officers of the fund, and the other service providers involved in the calculations of fair values.[521] BDCs face similar conflicts of interest, which likewise should be managed by their boards. The final 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 valuation designees in the fair value determination process.

2. Board Considerations When Designating Fair Value Determinations

Under the final rule, boards may designate the performance of fair value determinations for investments of the fund to a valuation designee.[522] It is our understanding that funds' advisers or officers of internally managed funds already perform or assist the board with respect to many of those functions subject to the board's oversight. When deciding whether to designate a party to perform fair value determinations for the fund, we anticipate that a board will consider certain trade-offs. In particular, fund boards' decisions to oversee valuation designees' fair value

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520 *See*, *e.g.*, Brown and Davies 2017.

521 *See supra* footnote 423.

522 *See* rule 2a-5(b).

determinations instead of determining fair value themselves may depend on the number, amount, or allocation of investments that must be fair valued, the nature and complexity of the valuation of those investments, the type of fund, the valuation designee's willingness to assume additional fair value responsibilities, and the fund's current practices. Boards' decisions may also depend on the resources of the valuation designee.[523] Boards of funds that hold more investments that must be fair valued and harder-to-value investments may be more likely to designate a valuation designee to perform these fair value determinations and to oversee the process of determining fair value by the valuation designee because valuation designees may be better suited to value those types of investments. A board's decision 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 designate the performance of fair value determinations (on which the fund's NAV is based) to a valuation designee than the board of a fund that calculates value less regularly. As another example, the board of a BDC may choose to determine fair value itself through its officers due to specialized expertise retained internally.

The decision to oversee valuation designees' fair value determinations may also depend on valuation designees' willingness to assume the designated responsibilities. Such willingness may depend on the valuation designee's valuation expertise and experience, whether the valuation designee has available resources to satisfy new obligations, and the extent to which the valuation designee could be compensated for those increased responsibilities, including by passing through to the fund and its investors any higher costs. Finally, a board's decision to designate responsibilities under the final rule may depend on the expected costs of compliance, which ultimately depend on how different the fund's current practices and policies and procedures are from the requirements of the final rule.

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523 *See supra* footnote 295 and accompanying discussion.

We lack comprehensive information on funds' current fair value practices and do not have visibility into boards' decision-making processes when seeking assistance with fair value determinations from valuation designees.[524] Further, boards' decision-making processes with respect to seeking assistance with fair value determinations from valuation designees is complex. Hence, we are unable to estimate precisely the number of fund boards that will designate responsibilities to a valuation designee under the final rule instead of the boards making fair value determinations in good faith themselves. Nevertheless, we believe the vast majority of boards will designate these responsibilities to a valuation designee[525] because the valuation designee has valuation experience and expertise, 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. We believe this is true regardless of whether the board designates an adviser or an officer of the fund to perform the valuation responsibilities. Further, valuation designees already provide significant assistance with the fair value determinations to the board of directors and so funds that designate a valuation designee to perform fair value determinations under the final rule should not need to modify their operations significantly to comply with the final rule. For the purpose of our economic analysis, we assume all funds with some investments that need to be fair valued under the final rule are affected parties.

2. General Discussion of Benefits and Costs of Good Faith Determinations of Fair Value

Overall, the requirements of the final rule provide a framework for appropriate oversight of determinations of fair value in good faith. As such, the final rule helps the board oversee the fund and helps to promote, for example, the mitigation of conflicts of interest of those involved in the fair value process and in the management of investments and the management of the fund

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524 The industry reports cited in section II above only provide qualitative information on certain aspects of funds' current practices. *See also supra* footnote 419 for a discussion of limitations of the Deloitte survey data. Funds have discretion in the type of disclosures they provide regarding their fair value determinations. As discussed throughout section III.B.2, commenters provided descriptions of current practice.

525 Commenters agreed with this view. *See, e.g.*, IDC Comment Letter.

for the benefit of the fund's shareholders. Another benefit arising from appropriate oversight of the fair value process is that fair value determinations will be more likely to reflect a price that could be obtained in arm's length transactions with less bias. This will contribute to better measurement of the risk and return profile of individual investments and their contribution to the risk and return profile of the fund, which will help promote the management of the fund in accordance with its investment objectives; ensure the accuracy of asset-based and performance-based fee calculations; and affect the accuracy of disclosures of fund fees, performance, NAV, and portfolio holdings.

Similarly, as less biased fair value determinations help to ensure that a fund's value more accurately reflects the value that a current arm's length transaction would produce when purchasing or selling fund shares, as well as in cross trades, the final rule aims to provide investors their pro rata share of the fund's assets. Thus, proper valuation promotes the purchase and sale of fund shares at fair prices, and helps to avoid dilution of shareholder interests. Furthermore, investors may have stronger assurance that they can rely on valuations to express the risk and return profile of a fund, making investors' decisions better informed. Thus, investors may be better able to evaluate a fund and consider whether a fund fits into their investment goals in terms of returns and risk (*e.g.*, ability and willingness to bear risk). Improper valuation can cause investors to pay fees that are too high or to base their investment decisions on inaccurate information.

Finally, as described in the proposal, the increased specificity of the rules could reduce compliance costs for some funds that may expend less effort and time to design policies and procedures, reporting, and recordkeeping than trying to determine appropriate compliance under the statute alone. For funds whose current practices are more burdensome than the requirements of the rules, this increased specificity also could reduce compliance costs to the extent that funds might be less likely to put in place overly burdensome and unnecessary policies and procedures, reporting, and recordkeeping to comply with the statute. Relatedly, the rules and rescission of

existing no-action letters and guidance may increase certainty because funds will follow a single rule rather than following various no-action letters and guidance when determining fair values, which could ultimately reduce compliance costs. Conversely, to the extent that the specificity of the requirements of the rules prompts some funds or advisers to devote greater resources to ensure compliance with their fair value obligations, the requirements of the rules may impose greater costs on such funds and advisers. Changes in costs of compliance for funds or advisers ultimately could affect fund investors to the extent that any changes in costs would be passed down to them in the form of changed fund operating expenses.

In the next section, we discuss the benefits and costs; in a subsequent section, we discuss effects on efficiency, competition, and capital formation.

D. Benefits and Costs

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

Rule 2a-5 sets forth certain required functions that must be performed to determine the fair value of the fund's investments in good faith. As discussed above,[526] we are adopting these required functions substantially as proposed, with several changes from the proposal based on the comments the Commission received. These required functions constitute an important part of the framework that the final rule establishes and thus contribute to the benefits described in section III.C.3 To the extent that a function required by the final rule is in line with a fund's current practice, the additional costs and benefits described below are likely to be limited with respect to the fund.

a) Periodically Assess and Manage Valuation Risks

The final rule will require the periodic assessment of any material risks associated with the determination of the fair value of the fund's investments, including material conflicts of interest, and management of those identified valuation risks. The final rule does not specify

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[526] *See supra* section II.A.

which risks are to be assessed or the frequency of reassessments.[527] As discussed above, many funds or their advisers already periodically assess and manage their valuation risks.[528] Some fund boards may not, however, assess such risks for all investments, including, for example, those with level 2 inputs.[529]

To the extent that funds or valuation designees do not currently assess and manage valuation risks, the final rule will impose both one-time costs to develop or augment practices that conform to the requirements of the final rule as well as ongoing costs associated with implementing those practices. Likewise, to the extent that funds experience additional costs associated with developing or augmenting practices to conform with the requirements of the final rule to assess and manage valuation risks, these costs may be less burdensome for larger funds that could spread any such costs across a larger amount of assets under management. The final rule will, however, provide investors the benefit of assurances that mechanisms are in place to identify, assess, and manage valuation risks. To the extent that funds or valuation designees already assess and manage valuation risks in a manner consistent with rule 2a-5, the final rule will not impose any additional ongoing costs or present any additional ongoing benefits; such funds or valuation designees may have a one-time cost associated with reviewing the requirements of the final rule and ensuring that their practices conform to the requirements.

b) Establish and Apply Fair Value Methodologies

(1) Select and Apply Appropriate Fair Value Methodologies

The final rule will require funds or valuation designees to select and apply in a consistent manner appropriate fair value methodologies for determining (which includes calculating) the fair value of fund investments.[530] The final rule permits methodologies to be changed (so long as

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527 *See supra* section II.A.1.

528 *See supra* section III.B.2.b).

529 *See, e.g.*, Capital Group Comment Letter; IAA Comment Letter.

530 *See supra* section II.A.2.

the different methodology is equally or more representative of the fair value of fund investments)[531] and does not require funds or valuation designees to specify methodologies that will apply to anticipated or intended investments. As a matter of course in performing fair value determinations, we understand that funds or valuation designees currently establish and apply fair value methodologies.[532] Some fund boards may not, however, consistently use these methodologies for all investments.

To the extent that funds currently deviate from the requirements of the final rule to select and apply in a consistent manner fair value methodologies, the final rule will impose additional costs on funds or valuation designees. For example, a fund currently may make fair value determinations for certain securities, but not clearly select and apply the fair value methodology used to do so; under the final rule, the fund would have to clearly select and apply that methodology in a consistent manner. We recognize that there will be costs for funds that do not currently select and apply fair value methodologies in a consistent manner for all fund investments without readily available market quotations as defined in the final rule. These costs include one-time costs to evaluate the requirements of the final rule and make changes to practices as well as ongoing additional costs due to implementing these changes on an ongoing basis (*e.g.*, determining fair value in good faith for assets that rely on level 2 inputs). Likewise, to the extent that funds experience additional costs associated with developing or augmenting practices to conform to the requirements of the final rule to select and apply fair value methodologies in a consistent manner, these costs may be less burdensome for larger funds that could spread any such costs across a larger amount of assets under management.

(2) Periodically Review Appropriateness and Accuracy of Selected Methodologies

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531 *See supra* footnote 57 and accompanying discussion in section II.A.2.a).

532 *See supra* section III.B.2.

The final rule will require the periodic review of the appropriateness and accuracy of the valuation methodologies selected. The final rule will also require that funds make changes or adjustments to existing methodologies where necessary. As discussed above, many funds already incorporate such reviews into their current practices.[533] However, some fund boards may not conduct these periodic reviews for all methodologies. To the extent that funds already periodically engage in such reviews that are currently consistent with the final rule, the final rule will not impose any additional ongoing costs or present any additional ongoing benefits; such funds will have a one-time cost associated with reviewing the requirements of the final rule and ensuring that their practices conform to the requirements. However, for funds that do not currently conduct such reviews, the final rule will impose both one-time costs to create practices that conform to the requirements of the final rule as well as ongoing costs arising from these new reviews, but will provide the benefit of promoting appropriate methodologies and improving the governance for such funds.

(3) Monitor for Circumstances That May Necessitate the Use of Fair Value

The final rule will require that funds or valuation designees monitor for circumstances that may necessitate use of fair value.[534] As discussed above, this monitoring is common in practice,[535] though some fund boards may not monitor for such circumstances with respect to all fund investments.[536] To the extent that funds already engage in such monitoring, the final rule will not impose any additional ongoing costs or present any additional ongoing benefits; such funds may have a one-time cost associated with reviewing the requirements of the final rule and ensuring that their practices conform to the requirements. However, for funds that did not

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533 *See supra* section III.B.2.c).

534 *See supra* section II.A.2.c).

535 *See supra* section III.B.2.c).

536 *See, e.g.*, ABA Comment Letter; IAA Comment Letter; Scheidt Comment Letter 1 (stating that "funds are required to adopt policies and procedures that require monitoring for circumstances that may necessitate the use of fair value prices" under the compliance rule); SIFMA AMG Comment Letter.

previously conduct such monitoring, the final rule will impose both one-time costs to create practices that conform to the requirements of the final rule as well as ongoing costs of monitoring, but will provide the benefit of ensuring that investments for which market quotations become unreliable will have fair value determined for them. Likewise, to the extent that funds bear additional costs associated with developing or augmenting practices to conform to the requirements of the final rule to monitor for circumstances that may necessitate the use of fair value, these costs may be less burdensome for larger funds that could spread any such costs across a larger amount of assets under management.

c. Test Fair Value Methodologies for Appropriateness and Accuracy

The final rule will require that the board or valuation designee, as applicable, test the appropriateness and accuracy of the fair value methodologies that have been selected, including by identifying testing methods to be used and determining the minimum frequency with which such testing methods are used.[537] As discussed above, this practice is common.[538] Some funds may not, however, currently conduct this type of testing or apply these testing methods as the final rule requires with respect to all fund investments. To the extent that funds already engage in such testing, the final rule will not impose any additional ongoing costs or present any additional ongoing benefits; such funds may have a one-time cost associated with reviewing the requirements of the final rule and ensuring that their practices conform to the requirements. However, for funds that did not previously conduct such testing or conducted testing in a manner that differs from the requirements of the final rule, the final rule will impose both one-time costs to create practices that conform to the requirements of the final rule as well as ongoing costs associated with testing of fair value methodologies. Likewise, to the extent that funds bear additional costs associated with developing or augmenting practices to conform to the

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537 *See supra* section II.A.3.

538 *See supra* section III.B.2.d).

requirements of the final rule to test fair value methodologies for appropriateness and accuracy, these costs may be less burdensome for larger funds that could spread any such costs across a larger amount of assets under management.

One commenter noted specifically that "requirements around back testing, calibration, transparency and evaluation of inputs may require valuation designees to develop additional data science capabilities to analyze valuation data and perform necessary testing."[539] We recognize that, to the extent that the board or valuation designee, as applicable, determines that tests for which the board or valuation designee does not currently have capabilities should be performed, there will be costs attendant to the development or acquisition of these capabilities. However, these costs may be mitigated for a number of reasons. First, not all boards or valuation designees, as applicable, will need to perform such tests. For example, as noted above, while we continue to believe that calibration and back-testing can be particularly useful testing methods, the final rule does not require that calibration and back-testing be performed, nor does it preclude boards or valuation designees, where applicable, from using other appropriate testing methods on fair value methodologies.[540] Second, experience in back-testing, calibration, and evaluation of inputs is common in the industry.[541] Relatedly, special data science capabilities are not required for standard testing techniques that have been common for decades. As such, there is unlikely to be a need to develop additional capabilities for all funds.

d. Pricing Services

The final rule provides that determining fair value in good faith requires the oversight and evaluation of pricing services, where used. The final rule will require that, where funds or valuation designees engage a pricing service, the fund or valuation designee establish a process

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539 *See* SIFMA AMG Comment Letter.

540 *See supra* section II.A.2.b) and section II.A.3.

541 *See supra* section III.B.2.d).

for approvals, monitoring, and evaluation of each pricing service.[542] Funds or valuation designees, as applicable, must establish a process for price challenges. As discussed above, it is common practice for funds or valuation designees to evaluate and monitor pricing services and to challenge prices from pricing services.[543] The Commission has previously stated that technical assistance by non-directors must be carefully reviewed by the directors.[544] Valuation designees (including, for example, small advisers) may not, however, currently have the exact processes for monitoring and evaluating pricing services prescribed by the final rule.

To the extent that funds already have a process for the approval, monitoring, and evaluation of pricing services in the precise manner prescribed by the final rule, the final rule will not impose any additional ongoing costs or present any additional ongoing benefits; such funds may have a one-time cost associated with reviewing the requirements of the final rule and ensuring that their processes conform to the requirements. Likewise, to the extent that funds bear additional costs associated with developing or augmenting practices to conform to the requirements of the final rule to oversee and evaluate pricing services, these costs may be less burdensome for larger funds that could spread any such costs across a larger amount of assets under management.

The requirement to establish a process for price challenges will impose some burdens on some funds or valuation designees. To the extent that funds already have processes for price challenges, the final rule will not impose any additional ongoing costs or present any additional ongoing benefits; such funds will have a one-time cost associated with reviewing the requirements of the final rule and ensuring that their practices conform to the requirements. However, for funds that did not previously establish such processes, the final rule will impose both one-time costs to create practices that conform to the requirements of the final rule as well

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542 *See supra* section II.A.4.

543 *See supra* section III.B.2.f).

544 *See* Proposing Release, *supra* footnote 2, at n.16; ASR 118.

as ongoing costs, such as implementation of these processes. The final rule will also provide the benefit of oversight of price challenges that should mitigate conflicts of interest between shareholders and valuation designees to the extent that such conflicts exist. For example, the final rule should mitigate conflicts of interest where valuation designees may otherwise engage in price challenges that distort determinations of fair value in order to increase their compensation or make their performance appear to be better than it otherwise would.

e. Fair Value Policies and Procedures

In connection with the final rule, and as discussed above, to comply with the compliance rule, each fund must adopt and implement written policies and procedures that are reasonably designed to prevent violations of the final rule. To comply with the compliance rule, these fair value policies and procedures must be tailored to the final rule's requirements.[545] A fund may rely on an adviser's policies, which should eliminate duplication and mitigate costs. In a change from the proposed rule, the final rule does not have an explicit requirement to adopt written policies and procedures as this is already required by the compliance rule. As discussed above, funds must adopt and implement written policies and procedures for fair value determinations under the compliance rule, so all funds must maintain written fair value policies and procedures.[546] To the extent that funds already maintain written fair value policies and procedures that are aligned with reasonably preventing violations of the requirements of the final rule, the final rule will not impose any additional ongoing costs or present any additional ongoing benefits; such funds will have a one-time cost associated with reviewing the requirements of the final rule and conforming their policies and procedures accordingly. Likewise, to the extent that funds bear additional costs associated with changes to policies and procedures to conform to the requirements of the final rule, these costs may be less burdensome

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545 *See supra* section II.A.5.

546 *See supra* section III.B.2.

for larger funds that could spread any such costs across a larger amount of assets under management.

2. *Performance of Fair Value Determinations*

As discussed above,[547] the final rule will permit the board to carry out all of the fair value functions required in paragraph (a) of the final rule or to designate the fund's adviser or an officer or officers of the fund to perform fair value determinations relating to any or all fund investments, subject to the board's appropriate oversight. Boards may only designate to these valuation designees, though the trustee or depositor will perform the fair value functions in paragraph (a) of the final rule for UITs, which do not have a board or adviser.

A number of commenters suggested that the costs of rule 2a-5 as proposed would be significant for UITs, particularly for pre-existing ones,[548] as valuations for UITs are generally performed by parties other than trustees. We believe that the universe of existing UITs that will be relying upon this provision will be small, as we believe that (1) the insurance company (acting as depositor) generally provides valuation services for separate accounts formed as UITs, (2) similarly, ETF UITs typically utilize the trustee for valuation services, and generally hold investments that have readily available market quotations, and (3) other UITs often already use a trustee or depositor to perform valuation and, to the extent otherwise, generally have a short, fixed-term existence.

As discussed above, funds commonly engage advisers to assist them in performing fair value determinations, and the Commission has stated 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).[549] To the extent that funds' practices conform precisely to what is required under the

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547 *See supra* section II.B.

548 *See, e.g.*, AAM Comment Letter; Chapman Comment Letter; First Trust Comment Letter; Hennion & Walsh Comment Letter.

549 *See supra* section III.B.2.a).

final rule, the final rule will not impose any additional ongoing costs or present any additional ongoing benefits; such funds may have a one-time cost associated with reviewing the requirements of the final rule and ensuring that their practices conform to the requirements. However, for boards that did not previously engage valuation designees to assist in performing fair value determinations, the final rule permits a board to leverage the expertise of valuation designees with deeper and more specialized experience to conduct fair value determinations. Doing so will come with a cost, but will also come with the benefit of permitting the fund's board to focus on providing appropriate oversight under the final rule.

Explicitly allowing boards to designate a valuation designee to perform fair value determinations allows boards to allocate the fair value responsibilities to that party, 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.[550] The final rule will have larger effects on any boards that choose, under the final rule, to designate a valuation designee.

For a fund whose board designates the fund's adviser to perform fair value determinations, one-time costs associated with reviewing the final rule to ensure that practices conform to requirements of the final rule may be borne by the adviser, the fund, or both, depending on the fund's governing documentation or advisory agreements, and could be ultimately passed through to the fund's shareholders in the form of higher management fees or other expenses in the future.[551] For funds whose boards determine the fair values themselves,

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550 While this benefit will accrue to internally managed funds that will now similarly be permitted to designate to an officer or officer of the fund, it will not accrue to UITs because they do not have boards that may designate. Under the final rule the trustees or depositors of UITs (or other entities designated in the documentation of existing UITs) will carry out the requirements of the final rule. *See* final rule 2a-5(d). However, *see, e.g.*, Capital Group Comment Letter and American Funds Comment Letter, in which commenters characterized the proposed rule as prescriptive, requiring boards to be involved "in the weeds" and distracted by "voluminous reports" rather than freeing up board resources and effectively focusing the board on oversight. Changes to the rules reduce the prescriptiveness compared to the proposed rule. S*ee supra* section II.B.2.

551 *See* Capital Group Comment Letter; Guggenheim Trustees Comment Letter.

these costs will be borne by the fund, and those one-time costs, if any, could be ultimately passed through to the fund's shareholders in the form of higher operating expenses.

Relatedly, to the extent that an adviser to the fund is designated to perform fair value determinations that it is not currently performing, depending on the fund's governing documentation or advisory agreements, such an adviser or the fund may incur ongoing costs to satisfy its new fair value obligations. Similarly, to the extent that an officer of the fund performs the fair value determinations, the fund itself could directly incur higher ongoing costs, if any higher costs occur, though it would also benefit from improved governance of the fair value process. Those costs and benefits will be attributable to adopting and implementing assessment and testing practices, methodologies, reporting, and recordkeeping to ensure compliance with the rules' requirements. The magnitude of those costs and benefits will depend on how funds' or their advisers' current practices compare to the requirements of the rules. To the extent that advisers currently engage in the fair value process as permitted by the final rule and in accordance with its requirements (and thus currently incorporate the costs of doing so in their compensation), additional ongoing costs (including the extent to which any costs are passed on to fund investors) and benefits are likely to be limited.

Similarly, to the extent that an officer of the fund currently performs fair value determinations in accordance with the requirements of the final rule and is already compensated for such duties and responsibilities, such an officer is unlikely to demand higher wages. A valuation designee designated by the board to perform fair value determinations relating to any or all fund investments will, as discussed above, also be subject to appropriate oversight, including through board reporting.[552]

We discuss the costs and benefits of this oversight and reporting below. The elements of oversight and reporting constitute an important part of the framework that the final rule

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552 *See supra* section II.B. *See also supra* footnote 141 (discussing the change to permit designation to officers of internally managed funds).

establishes and thus contribute to the benefits described in section III.C.3. To the extent that a requirement of the final rule is in line with a fund's current practice, additional costs and benefits are likely to be limited with respect to the fund.

a) Board Oversight

As discussed above, the final rule, similar to the proposed rule, will require a board to oversee any valuation designee designated to perform fair value determinations.[553] Also, as discussed above, it is a common practice that boards provide oversight of valuation designees engaged to perform fair value determinations.[554] Because boards already provide oversight of valuation designees engaged to perform fair value determinations, the final rule is not likely to impose any additional ongoing costs or present any additional ongoing benefits; such funds will have a one-time cost associated with reviewing the requirements of the final rule and ensuring that their practices conform to the requirements. There may, however, be some boards that, in exercising their oversight obligations, currently undertake to perform more tasks than will be required by the final rule, including, for example, the ratification of specific fund fair values daily or periodically. To the extent that these boards choose to cease these practices, this could result in a reduction in benefits that are associated with a board undertaking these additional duties as well as a reduction in any associated costs. Such a change in oversight practice may reduce the costs of boards' resources spent on such day-to-day involvement and provide the benefit of directing those resources to more productive and critical areas of board oversight of the fair value process or to other oversight obligations that the board has with respect to the fund.

To the extent that certain funds' fair value practices currently are less thorough than those required under the final rule the final rule could decrease the likelihood that fund investments are inappropriately fair valued.[555] This is because, for these funds, the final rule should create a more

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553 *See supra* section II.B.1.

554 *See supra* section III.B.2.

555 *See supra* section III.C.1 for a discussion related to advisers' conflicts of interest.

robust valuation framework to address conflicts of interest of the valuation designee, which could result in less biased determinations of asset valuations. Nevertheless, the final rule's effect on mitigating conflicts of interest and on the accuracy of fair value determinations may be limited, as it is our understanding that many funds currently have in place fair value practices that are similar to the requirements of the final rule and that boards oversee the valuation designee's assistance with fair value calculations, including the role of pricing services in the fair value process.[556]

In addition, under the final rule, if the fund is a UIT, the fund's trustee or depositor must carry out the fair value determinations.[557] Hence, UITs will not bear any costs associated with oversight and reporting. We expect the effects of all other aspects of the final rule to be similar for UITs and other funds.

We believe that funds' incremental ongoing costs associated with this aspect of the final rule will be limited to the extent that boards or funds currently engage in appropriate oversight of a valuation designee's assistance with fair value calculations and that boards currently review periodic and ad-hoc reports related to fair value determinations prepared by the fund's valuation designee in a manner and to an extent consistent with the requirements of the final rule.[558] Commenters stated that boards lack the expertise and resources to perform fair value determinations in good faith[559] and that few boards perform this function themselves.[560] Hence, we believe that incremental ongoing costs on boards and fund investors compared to the ongoing costs under current practices will be limited to the extent that boards are already performing

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556 *See supra* section III.B.2. These costs and benefits are similar for internally managed funds seeking to designate to an officer or officers under the final rule.

557 *See* final rule 2a-5(d).

558 As discussed above, the final rule has been made less prescriptive than the proposed rule, thus narrowing the gap between practice and the requirements.

559 *See, e.g.*, ABA Comment Letter; JPMAM Comment Letter; NYC Bar Comment Letter.

560 *See, e.g.*, ABA Comment Letter; Baillie Gifford Comment Letter; Fidelity Comment Letter; IAA Comment Letter; MFS Comment Letter.

appropriate oversight in a manner and to an extent consistent with the final rule.[561] We acknowledge, however, that to the extent boards' current oversight of valuation designees' fair value calculations and boards' current practices with respect to review of valuation reports are inconsistent with appropriate oversight as discussed above,[562] funds may bear higher additional ongoing costs to comply with the final rule.

b) Board Reporting

The final rule will require the valuation designee to provide periodic reports and prompt notification of matters that materially affect the fair value of the designated portfolio of investments.[563] For funds whose boards will designate valuation designees to perform fair value determinations, the final rule could impose additional ongoing costs associated with boards' appropriate oversight of the valuation designee's fair value determinations and review of board reports. Some commenters suggested the ongoing costs of reporting would be high, due in part to "substantially more information" being provided to boards prompted by the proposed rule, and would provide little or no benefit.[564] In response to these commenters, the final rule contains certain changes to the proposed board reporting requirements designed to, among other things, reduce the chance that boards receive reporting that is too detailed or repetitive.[565] We discuss the costs and benefits of these periodic and prompt reporting requirements below.

(1) Periodic Reporting

The final rule, like the proposed rule, will require that certain reporting be provided to the board on a quarterly basis and certain reporting on an annual basis.[566] As discussed above,

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

562 *See supra* section II.B.

563 *See supra* section II.B.2.

564 *See, e.g.*, American Funds Comment Letter; Capital Group Letter; Dechert Comment Letter; Guggenheim Comment Letter; ICI Comment Letter; SIFMA AMG Comment Letter.

565 *See supra* text accompanying footnote 229.

566 *See supra* section II.B.2.a).

periodic reporting to boards on matters of fair value determination is common practice.[567] Currently, the board may not receive quarterly or annual reports, and may receive more or less frequent reporting depending on the type of fund investments and the market conditions.

Funds will have a one-time cost associated with reviewing the requirements of the final rule and ensuring that their practices conform to the requirements. To the extent that boards do not receive periodic reporting that conforms to the requirements of the final rule, the final rule will impose additional ongoing costs to valuation designees, such as providing additional reports or more frequent reports as required by the final rule or reports of different information. Similarly, the boards of these entities will incur ongoing costs related to reviewing such reports. The final rule's requirement to assess the adequacy and effectiveness on an annual basis will, for example, to the extent that a valuation designee does not do so on an annual basis, increase a valuation designee's costs as well as the board's costs of reviewing such reports. Further, the final rule's requirement that quarterly reports include material changes in assessment or management of valuation risks will, to the extent that a valuation designee does not report material changes in assessment or management of valuation risks or does not do so on a quarterly basis, increase a valuation designee's costs as well as the board's costs of reviewing such reports. The final rule's requirement for a summary of testing results and assessment of adequacy of resources on an annual basis will, to the extent that a valuation designee does not report testing results or an assessment of adequacy of resources or does not do so on an annual basis, increase their costs as well as the board's costs of reviewing such reports. In addition, to the extent that these reporting requirements increase the volume of information that boards must review, board members may seek higher fees or may devote less time to other issues, which may impact the general effectiveness of the board. Furthermore, to the extent that the board consults outside counsel or other experts, such as accountants, with respect to such reporting, there may be

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567 *See supra* section III.B.2.g).

additional external expenses incurred. These costs could be passed on to investors. However, to the extent that the requirement of the final rule for periodic reporting aligns with a fund's current practice, this requirement of the final rule may impose additional costs or contribute additional benefits of improved board oversight of the fair value process.

Certain funds might put in place reporting procedures to comply with the final rule that are more costly than those funds' current practices, while other funds might set up reporting as a result of the final rule that will result in lower ongoing costs than the costs of current practice. We acknowledge that funds whose reporting is less costly than that required under the final rule will bear additional ongoing costs under the final rule.

(2) Prompt Board Notification

The final rule will require the valuation designee to provide a written notification of the occurrence of material matters, including significant deficiencies or material weaknesses in the design or effectiveness of the valuation designee's fair value determination process or material errors in the calculation of net asset value. This notification must take place within a time period determined by the board, but in no event later than five business days after the valuation designee becomes aware of the material matter. The valuation designee must also provide such timely follow-on reports as the board may reasonably determine are appropriate. As discussed above, it is common practice to require that certain matters be reported promptly to the board, though the content and frequency of current ad hoc reporting to boards may vary depending on the type of fund and fund investments.

To the extent that funds do not already provide boards with prompt reporting on matters as required in the final rule, the final rule will impose additional ongoing costs such as preparing reports more quickly or more often than waiting for routine reporting. Specifically, the final rule requires written notification of the occurrence of material matters in no event later than five business days after the valuation designee becomes aware. This will impose costs on valuation designees, including costs of diverting or expending additional resources, to meet the required

timeline. In addition, the final rule's definition of material matters may include matters for which some boards do not currently receive reports, which could impose additional burdens on valuation designees producing additional reports and on boards' time and attention and related external costs. The requirement to provide such timely follow-on reports as the board may reasonably determine are appropriate may impose similar costs to the extent boards do not receive such reporting already. Also, funds and valuation designees may have a one-time cost associated with reviewing the requirements of the final rule and conforming their practices to the requirements.

Overall, as discussed previously, the changes to the reporting requirements of the final rule reduce the burden and cost of required prompt board reporting under the final rule compared to the requirements of the proposed rule. Valuation designees will have relatively reduced reporting burdens and the relatively reduced reporting to the board will permit the board to more effectively and more efficiently focus on its oversight role.

c) Specification of Functions and Reasonable Segregation from Portfolio Management

The final rule, like the proposed rule, will require that the valuation designee (a) specify the titles of the persons responsible for determining the fair value of designated investments, including by specifying the particular functions for which they are responsible, and (b) reasonably segregate portfolio management from fair value determinations.[568] As discussed above, similar practices are common among advisers performing fair value determinations.[569]

To the extent that funds do not already specify functions as required in the final rule, the final rule will impose additional ongoing costs, such as reviewing and specifying functions in accordance with the final rule. Specifically, the requirement to specify the titles of the persons responsible for determining the fair value of the designated investments, including by particular

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568 *See supra* section II.B.3.

569 *See supra* section III.B.2.e).

function and as related to price challenges, may impose costs, including those related to identifying clearly those responsible for price challenges to the extent funds do not do so already. In addition, the final rule's requirement for the valuation designee to segregate fair value determinations from the portfolio management of the fund reasonably will impose costs to the extent that such reasonable segregation results in a decrease in quality or quantity of information provided by portfolio managers or an increase in staffing to ensure compliance with the final rule. Costs will vary, based in part on whether a fund establishes new processes to institute this requirement, which could include independent reporting chains, oversight arrangements, or separate monitoring systems and personnel. All funds subject to this requirement may have a one-time cost associated with reviewing the requirements of the final rule and ensuring that their practices conform to the requirements.

Whenever the fund's adviser is designated to perform fair value determinations, the requirement to segregate fair value determinations from portfolio management reasonably may be more costly for smaller advisers, and smaller internally managed funds, with limited resources and personnel, than for larger ones. The reason is that smaller advisers, and smaller internally managed funds, may lack the staff and resources to segregate portfolio management personnel from those making fair value determinations reasonably as efficiently as larger advisers, and internally managed funds, or may only be able to meet this requirement by hiring additional personnel. As such, the reasonable segregation requirement of the final rule allows a fund to make decisions about tradeoffs it faces (*e.g.*, costs, benefits, risks) in the context of the specific facts and circumstances of the fund.

Finally, to the extent that the board designates the valuation designees to perform the fair value determinations relating to any or all of fund investments, the final rule will provide the valuation designee —which has conflicting interests—a greater permissible role in fair value

determinations relative to current practices.[570] Nevertheless, we believe that any impact from such conflicts may be mitigated because the final rule contains explicit requirements related to the identification, assessment, and management of any material conflicts of interest of the valuation designee as well as the requirement to reasonably segregate the valuation designee's fair value determinations from portfolio management, and most funds currently have in place policies to manage conflicts of interest of valuation designees that may not be valuation specific.

One commenter stated that the proposed rule lacked clarity as to which individuals are required to be identified and stated that "little appears to be gained by the mechanical exercise" of naming individuals and their titles, which may be generic, and identifying with specificity their roles in the valuation function.[571] As discussed more extensively above, we disagree with the commenter because this requirement in the final rule cannot be satisfied by simply listing the generic titles of those involved in valuation.[572] As a result, this requirement may result in costs, as described above, but also benefits resulting from the improved oversight and accountability which would not be provided by listing generic titles.

3. Recordkeeping

Rule 31a-4 will require that a fund or designated adviser maintain appropriate documentation to support fair value determinations.[573] As discussed above, maintenance of such documentation is a common practice.[574] Some funds may not, however, maintain these records for all investments. For example, a fund may not maintain records for which the board relies on pricing services and investments with level 2 inputs as required under rule 31a-4.[575]

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570 *See supra* section II.B.3 for a discussion related to advisers' conflicts of interest.

571 *See* Sullivan Comment Letter.

572 *See supra* footnote 288 and accompanying discussion.

573 *See supra* section II.C.

574 *See supra* section III.B.2.h).

575 *See supra* section III.B.2.h).

Some commenters stated that the recordkeeping requirements associated with rule 2a-5 as proposed would represent a significant change from current practice and would entail additional costs.[576] Funds will have a one-time cost associated with reviewing the requirements of rule 31a-4 and ensuring that their practices conform to the requirements. To the extent that funds do not already maintain documentation to support fair value determinations that conforms to rule 31a-4, it will impose additional ongoing costs, including costs associated with updating documentation as practices change and evolve and maintaining records for six years. Certain funds or advisers might put in place recordkeeping practices to comply with rule 31a-4 that are more costly than the funds' or advisers' current practices, while other funds or advisers might set up recordkeeping practices as a result of rule 31a-4 that will result in lower ongoing costs than the costs of current practice. We continue to believe that funds' or advisers' incremental ongoing costs associated with rule 31a-4 will, however, be limited to the extent that, as discussed in section II.C above, funds or advisers currently have in place recordkeeping practices associated with fair value determinations that are similar to rule 31a-4's requirements.[577]

Some commenters suggested that the time and resources required in order to comply with the recordkeeping requirements would be higher than stated in the proposal, but without providing estimates.[578] While recordkeeping costs may be higher than estimated for some funds, to the extent that a fund's current recordkeeping practices are similar to the requirements of rule 31a-4, a fund will incur minimal additional ongoing costs. Likewise, to the extent that a fund's recordkeeping practices fail to meet the requirements of rule 31a-4, a fund will incur higher ongoing costs.

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576 *See, e.g.*, Baillie Gifford Comment Letter; Capital Group Comment Letter; ICE Data Comment Letter; ICI Comment Letter; MFS Comment Letter; SSGA Comment Letter; TRC Comment Letter; Vanguard Comment Letter. *See also supra* footnotes 310 and 311 and accompanying discussion.

577 As discussed above, the final rule has been made less prescriptive than the proposed rule, thus narrowing the gap between practice and the requirements.

578 *See* John Hancock Comment Letter; SIFMA AMG Comment Letter.

Maintaining certain documentation to support fair value determinations is an important element of the oversight framework that rule 2a-5 establishes and thus contributes to the benefits described in section III.C.3.[579] To the extent that rule 31a-4's requirements are in line with a fund's current practice, additional costs and benefits are likely to be limited.

4. Readily Available Market Quotations

The final rule defines a market quotation as 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." This definition will apply in all contexts under the Investment Company Act and the rules thereunder, including rule 17a-7.[580]

To the extent that funds currently consider some or all investments valued with level 2 inputs as investments with readily available market quotations, funds will incur costs related to fair valuing these investments. Specifically, if a fund currently treats certain investments valued with level 2 inputs as having readily available market quotations,[581] the fund will likely experience additional costs associated with the application of fair value practices and requirements of the final rule to those investments, as discussed above. For example, if such a fund currently views a level 2 input or the product of level 2 inputs for some securities as readily available market quotations, the fund will need to subject those securities to the fair value process. Depending on the fund's practices, this may merely mean documenting the due diligence it already performs; however, if the fund does not perform due diligence, then it will have to establish procedures to do so and document such due diligence. These costs could be passed on to investors. To the extent that the final rule reflects current industry practice (*e.g.*,

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579 *See supra* section III.C.3.

580 *See supra* section II.D.

581 *See, e.g.*, Capital Group Comment Letter; IAA Comment Letter.

properly fair valuing such securities and board reporting), there will be fewer, if any, additional costs or benefits arising from the definition in the final rule. As mentioned above, funds will incur one-time costs of reviewing the final rule and ensuring that practices conform to the final rule.[582]

The final rule's definition of readily available market quotations may also impose costs on funds that currently cross trade securities not captured by the definition. The application of this definition may result in funds that had previously viewed certain securities as having readily available market quotations, and thus eligible for cross trades under rule 17a-7, to re-evaluate practices for trading those securities or change their practices for trading those securities. This re-evaluation will impose costs on those funds and may result in those funds having a more restricted set of securities being available for cross trades than they had previously viewed as being available for cross trades.

Depending on the reasons for trading, cross trading may impact fund investors both positively and negatively. First, cross trading allows both trading funds to avoid commissions or other transaction costs that would otherwise be borne in a market transaction. Second, cross trading can allow a fund facing liquidity constraints to avoid depressed or fire-sale prices when it is selling an asset for which market prices would otherwise be depressed. However, since these transactions are not market transactions and can be affected by conflicts of interest, rule 17a-7 requires securities to have readily available market quotations to serve as an independent basis, and the "prices" at which cross trades execute are set internally based on the requirements of rule 17a-7.The final rule, by defining readily available market quotations, further mitigates the risk that one fund will "subsidize" another fund through cross trading of assets with more subjective values.[583]

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582 *See supra* section III.D.2.b) and section III.D.3.

583 *See* Alexander Eisele, Tamara Nefedova, Gianpaolo Parise, & Kim Peijnenburg, *Trading out of sight: An*

Funds may also bear the cost of going to market for trades that otherwise would have been implemented via a cross trade if the securities in question lack readily available market quotations. Such costs include transaction costs (such as bid-ask spreads or commissions) and search costs for hard-to-find securities. Based on the estimates presented in Table 2, approximately 33% of fund assets are fair valued with level 2 or level 3 inputs. However, we lack detailed data on funds' engagement in cross trading in such securities to estimate what fraction of this subset will be affected by the definition of readily available market quotation.[584] Likewise, we lack detailed data to estimate the transactions and other costs that a fund might incur if forced to go to the market for transactions that otherwise would have been executed with a cross trade. The final rule will have a larger effect on funds for which a larger percentage of their investments does not have readily available market quotations because those funds will be required to determine the fair value of a larger percentage of their investments.

As discussed above, commenters were concerned about requirements in the proposed rule to maintain records of specific methodologies, assumptions, and inputs for determining fair values, in particular for investments valued with level 2 inputs.[585] Commenters stated that the definition of readily available market quotations would effectively prompt funds to treat all investments valued with level 2 inputs as not having readily available market quotations.[586] Many suggested, in particular, that applying the proposed recordkeeping provisions to

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analysis of cross-trading in mutual fund families, 135 J. FIN. ECON. 359 (2020) ("Eisele et al. 2020"), which provides evidence of strategic reallocation of performance among sibling funds; and Gerald Abdesaken, *Conflicts of interest in multi-fund management*, 20 J. ASSET MGMT. 54 (2019) ("Abdesaken 2019"), which provides evidence of conflicts of interest among asset managers that simultaneously manage multiple mutual funds.

584 Approximately 28% of funds reported relying on 17a-7 for cross trades, but we cannot determine to what extent reliance on 17a-7 is limited to investments meeting the definition under the final rule of having readily available market quotations. *See supra* section III.B.3.

585 *See supra* section II.C.

586 *See, e.g.*, AIMA Comment Letter; American Bankers Association Comment Letter; American Funds Comment Letter; Baillie Gifford Comment Letter; Capital Group Comment Letter; Dechert Comment Letter; Guggenheim Comment Letter; IAA Comment Letter; ICE Data Comment Letter; ICI Comment Letter; IDC Comment Letter; SIFMA AMG Comment Letter; SSGA Comment Letter; TRC Comment Letter; Vanguard Comment Letter.

investments valued with level 2 inputs is not necessary and would impose additional costs.[587] To the extent that some funds currently treat some investments relying on level 2 inputs as having readily available market quotations, those funds will face higher costs associated with determining the fair value of those investments in good faith as required by the final rule. These costs could include compliance costs (*e.g.*, updating procedures for fair value determinations) or devoting greater resources to conduct due diligence of pricing services. As discussed above,[588] commenters described varying recordkeeping practices for investments relying on level 2 inputs, including documenting the due diligence and oversight of pricing services and maintaining prices received from a pricing service. To the extent that a fund's practices with respect to investments relying on level 2 inputs conform to the final rules, a fund will face few, if any, additional ongoing costs.

One commenter also stated that "challenges associated with the proposed rule's definition of 'readily available market quotations'" could discourage purchases of certain investments, particularly for smaller firms.[589] Another commenter expressed a similar concern about the definition and the costs of the proposed rule's requirements for establishing methodologies, inputs, and assumptions for prices provided by pricing services.[590] As discussed above, we agree that there will be additional costs for funds that currently treat investments that rely on level 2 inputs as having readily available market quotations. While there is a potential risk that initial purchases of certain investments may be discouraged, the commenter's concern with the "rigidity of the proposed rule," which required the specification of methodologies that would apply to new types of investments in which the fund intended to invest, is mitigated by changes to rule 2a-5, which does not include this requirement. Similarly, the other commenter's concern

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587 *See, e.g.*, Capital Group Comment Letter; SIFMA AMG Comment Letter.

588 *See supra* section II.C and section III.B.2.h).

589 *See* Guggenheim Comment Letter.

590 *See* Dechert Comment Letter.

with the proposed rule's requirement to establish methodologies, inputs, and assumptions for prices provided by pricing services is mitigated by changes to the final rule, which allows the due diligence process for pricing services to fulfill this requirement.

5. Rescission of Prior Commission Releases and Guidance

The final rule, like the proposed rule, rescinds certain Commission releases and guidance, including ASR 113, ASR 118, and prior guidance on the oversight of pricing services contained in the 2014 Money Market Fund Release.[591] To the extent that funds' interpretations of such Commission releases and guidance have led to funds' adoption of practices that do not conform to the requirements of the final rule, the final rule will impose additional initial and ongoing costs, but come with additional ongoing benefits. Furthermore, as described in the Proposing Release, some parts of the Commission releases and guidance have been superseded or made obsolete.[592] Similarly, one commenter stated that rescinding ASR 113 and ASR 118 will avoid potentially contradictory requirements[593] and other commenters stated that U.S. GAAP and related accounting rules play an informative role in the valuation process.[594] Because U.S. GAAP standards are commonly understood and used in the industry in financial reporting, both the additional one-time and ongoing costs of conforming to these standards and the final rule, rather than relying on Commission releases and guidance, should be limited. Finally, we believe that rescinding the auditing guidance included in ASR 118 will have little or no impact on funds or valuation designees because a fund board or valuation designee could request that its auditor continue current practice to verify 100% of the values of the fund's investments if it determines that this approach is preferable.

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591 *See supra* section II.E.

592 *See* Proposing Release, *supra* footnote 2, at n.150 and accompanying discussion.

593 *See* KPMG Comment Letter.

594 *See* ABA Comment Letter; E&Y Comment Letter.

The final rule provides a minimum, consistent framework for fair value and standard of baseline practices across funds to help ensure that boards fulfill their oversight roles appropriately, and these will encourage funds to adopt best practices to support more rigorous fair value determinations. The rescission of prior Commission releases and guidance obviates a fund's need to analyze and interpret those releases and guidance, thus reducing compliance costs.[595] As discussed above, some commenters opposed rescission of ASR 113 and ASR 118 stating that certain specific fair values are not covered in the relevant accounting standards and that certain content within those releases should be reissued or restated by the Commission, but we continue to believe that in light of the existing framework in U.S. GAAP, and upon adoption of rule 2a-5 in this document, these specific valuation matters do not require the specific incremental guidance included in the ASRs.[596] Lower costs of compliance for funds resulting from relying on the final rule rather than various guidance 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.

6. Cost Estimates

Rules 2a-5 and 31a-4 will affect all funds with investments that do not have readily available market quotations, their boards of directors, the advisers of most funds, and the depositors or trustees of UITs, though not all of those funds will have to materially change their practices to comply with the final rule. The effects of these rules depend on the extent to which funds' current practices differ from their requirements. Our staff estimates that the one-time incremental costs necessary to ensure compliance with these rules range from $100,000 to

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595 Academic literature provides evidence consistent with the idea that uncertainty has negative effects on investment and growth. *See, e.g.,* Nicholas Bloom, Stephen Bond, & John Van Reenen, *Uncertainty and Investment Dynamics*, 74 REV. ECON. STUD. 391 (2007); Nicholas Bloom, *The Impact of Uncertainty Shocks*, 77 ECONOMETRICA 623 (2009); Scott R. Baker, Nicholas Bloom, & Steven J. Davis, *Measuring Economic Policy Uncertainty*, 131 Q.J. ECON. 1593 (2016).

596 *See supra* section II.E.

$600,000 per fund, depending on the current fair value practices of the fund.[597] These estimated costs are attributable to the following activities: (i) reviewing the rules' requirements; (ii) developing new (or modifying existing) fair value policies and procedures,[598] reporting,[599] recordkeeping,[600] valuation risk assessment,[601] fair value methodology,[602] testing,[603] and pricing service oversight[604] practices to align with the requirements of the rules; (iii) implementing those policies and procedures, reporting, recordkeeping, valuation risk assessment, fair value methodology, testing, and pricing oversight practices and integrating them into 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 the valuation designee should be designated to perform fair value determinations and how to set up appropriate policies and procedures, reporting, and recordkeeping requirements.

Many commenters agreed that the requirements of the proposed rule would impose such costs[605] and some commenters stated that our estimates understated the costs described in the proposed rule.[606] However, such commenters did not provide specific estimates or data to inform

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597 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 final 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 final 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 final rule's requirements.

598 The final rule does not specify a requirement for policies and procedures beyond that in the compliance rule, but the final rule may affect the content of policies and procedures required for documentation of fair value determinations under the compliance rule. *See supra* section II.A.5, section III.B.2, and section I.A.1.e.

599 *See supra* section II.B.2, section III.B.2.g), and section III.D.2.b).

600 *See supra* section II.C, section III.B.2.h), and section III.D.3.

601 *See supra* section II.A.1, section III.B.2.b), and section III.D.1.a).

602 *See supra* section II.A.2, section III.B.2.c), and section III.D.1.b).

603 *See supra* section II.A.3, section III.B.2.d), and section I.A.1.c.

604 *See supra* section II.A.4, section III.B.2.f), and section I.A.1.d.

605 *See, e.g.*, Dechert Comment Letter; Guggenheim Trustees Comment Letter; ICI Comment Letter; IDC Comment Letter; Invesco Comment Letter; John Hancock Comment Letter; NYSSCPA Comment Letter; Scheidt Comment Letter 2; Stradley Comment Letter.

606 *See, e.g.*, Guggenheim Comment Letter; ICI Comment Letter; John Hancock Comment Letter.

more accurate cost estimates. As described above, the requirements of these rules will be less prescriptive and burdensome than the requirements of the proposed rule. Nonetheless, our estimates have not changed because these estimates are for the one-time costs described here. Such costs are unlikely to vary as a result of the differences between the requirements of the proposed rule and those of rules 2a-5 and 31a-4 as adopted. We expect that the one-time incremental cost necessary to ensure compliance with the rules depends on each 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 will be closer to the lower end of the range for funds whose current practices are more similar to the requirements of the rules and funds with fewer and easier-to-value fund investments. Further, the one-time costs will 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, we estimate that 9,804 funds will be affected by the rules, and thus incur one-time costs associated with the rules.[607] We estimate that 70% of one-time costs are attributable to funds reviewing and updating their current practices and related policies and procedures to comply with the final rule's requirements; 15% of one-time costs are attributable to funds reviewing and updating current recordkeeping processes to align with rule 31a-4's requirements; and the remaining 15% of one-time costs are attributable to funds reviewing and updating the current board reporting processes to comply with the final rule's requirements. Hence, we estimate the aggregate one-time costs of the final rule to range between $980.4 million and $5.9 billion.[608]

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607 *See supra* footnote 509.

608 $980.4 million = 9,804 affected funds x $100,000. $5.9 billion = 9,804 affected funds x $600,000. *See supra* footnote 509

Section IV below presents estimates of "collection of information"-related burdens[609] associated with rule 2a-5's board reporting and rule 31a-4's recordkeeping requirements and with the requirement, to comply with rule 38a-1 after our adoption of rule 2a-5, to adopt and implement written policies and procedures reasonably designed to prevent violations of the requirements of rule 2a-5. Our estimates of one-time costs in the economic analysis above subsume the estimates of initial burdens in section IV, as the former cover costs associated with a broader set of activities, as described above, that do not all relate to the collection of information. In addition, some funds with investments valued using non-level 1 inputs may incur ongoing costs, in addition to the one-time costs described above, associated with the rules' requirements. However, we believe that the level of ongoing costs associated with the requirements of the rules are generally similar to that associated with existing practices of funds with investments valued without readily available market quotations. As a result, the estimate of ongoing industry burdens of $504,973,451 per year[610] in section IV represents an upper bound on the incremental ongoing costs for funds affected by the rules.

7. Other Cost Considerations and Comments on Costs

Many commenters stated that costs would likely be higher than we estimated in the Proposing Release without quantifying those higher costs. In addition, some commenters presented a number of other costs—also without quantification—that were not included in our estimates in the Proposing Release. For example, one commenter stated that the proposed

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609 *See infra* footnote 637 and associated text.

610 The ongoing burden associated with board reporting is based on 20 hours x $368 (senior programmer) + 1.5 hours x $4,770 (combined rate for 4 directors) + 0.44 hours x $368 (compliance attorney) + an external burden of $3,180 = $17,859 for each affected fund, implying a total ongoing industry burden of $17,859 x 9,335 affected funds = $166,709,616. *See infra* section IV.B. The ongoing burden associated with recordkeeping is based on 35 hours x $63 (general clerk) + 35 hours x $96 (senior computer operator) + 35 hours x $368 (compliance attorney) = $18,445 for each affected fund, implying a total ongoing industry burden of $18,445 x 9,335 affected funds = $172,184,075. *See infra* section IV.B. The ongoing burden associated with rule 38a-1 is based on 5 hours x $329 (senior manager) + 5 hours x $466 (assistant general counsel) + 2 hours x $530 (chief compliance officer) + 1 hour x $365 (compliance attorney) + 2 hours x $4,770 (Board of Directors as a whole), implying a total ongoing industry burden of $16,940 x 9,804 affected funds = $166,079,760. *See infra* section IV.B. Therefore, the total ongoing industry burden associated with the final rule is $166,709,616 + $172,184,075 + $166,079,760= $504,973,451.

reporting requirements could even lead to increased self-imposed costs becoming industry standards.[611] As discussed above, to the extent that funds' reporting practices already conform to the requirements of the final rule, additional costs will be limited. Likewise, we believe it is unlikely that funds will engage in additional reporting that is not necessary for compliance with the final rule. A few commenters suggested the proposed rule would result in increased liability of funds, boards, and advisers in fulfilling their fair value responsibilities.[612] It is possible funds, boards, and advisers may incur liability in connection with their fair value responsibilities under the final rule, but they already may incur liability in this regard under the law.

E. Effects on Efficiency, Competition, and Capital Formation

Rules 2a-5 and 31a-4 may also have effects on efficiency, competition, and capital formation. Under the final rule, boards may designate a valuation designee to perform fair value determinations and may oversee the valuation designee'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, to the extent that boards currently determine fair value of investments themselves, the final rule could lead to more efficient use of boards' resources and therefore improve funds' governance of determinations of fair value in good faith for the benefit of investors.[613] Conversely, to the extent that fund boards do not currently determine fair value themselves and instead rely on an adviser to compute fair value in line with the requirements of the final rule, such boards are not likely to benefit from more efficient use of their resources. The final rule also could improve the efficiency of fund

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611 *See* Dechert Comment Letter.

612 *See* ICI Comment Letter; American Funds Trustees Comment Letter; Capital Group Comment Letter; SIFMA AMG Comment Letter.

613 As discussed above, some commenters disagreed that this would free up board resources. *See, e.g.*, Russell Comment Letter; Fidelity Comment Letter; MFS Comment Letter; John Hancock Comment Letter. The final rule does not impose requirements on the board that go beyond its present obligations, but does impose various specific requirements that are not currently expressly required. However, the final rule does provide an express mechanism such that a board is permitted to designate a valuation designee to perform actual determinations of fair value on a daily basis, thus avoiding a board's involvement in the day-to-day activities of fair value determination, while maintaining its critical oversight role.

operations because it will explicitly allow boards more flexibility to oversee the valuation designees' fair value determination, whether the fund boards currently make fair value determinations themselves or not.

As discussed above, for UITs, a UIT's trustee or depositor must conduct fair value determinations under the final rule.[614] To the extent that the assistance of other parties (such as evaluators) is necessary, trustees or depositors can seek that assistance consistent with the guidance above regarding obtaining the assistance of others. Thus, for UITs, the final rule explicitly places the responsibility on a UIT's trustee or depositor, as specified in the trust indenture of the UIT, to fulfill the requirements of the final rule to ensure appropriate oversight of the fair value determination process.

As discussed above, the final rule mandates oversight of a valuation designee, which could ultimately improve the efficiency and reduce the bias of funds' valuations. Similarly, the requirements for UITs to provide oversight of the fair value determination process could improve the efficiency and reduce the bias of UITs' valuations. The final rule could improve the efficiency of valuations because it may create a more rigorous valuation framework and could help mitigate any conflicts of interest of the valuation designees or, in the case of UITs, the trustee or depositor, which ultimately could result in less biased valuations. A potential increase in asset valuation efficiency could improve boards' monitoring of funds' and of valuation designees' performance and could benefit capital formation because less biased valuations permit the allocation of resources to more efficient use. As mentioned by a commenter, "[b]etter standards improve the transparency and stability of financial markets, contribute to the growth of stronger economies and lead to improved confidence for investors and users of valuation services."[615] Similarly, another commenter noted that "more accurate and neutral information"

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614 *See* section II.B. *See also* footnotes 174, 176, and 177 and accompanying discussion.

615 *See* IVSC Comment Letter.

could lead to positive economic consequences and improved decision-making.[616] Nevertheless, we believe that any such effects likely will be limited to the extent that funds currently have in place fair value practices that are generally similar to the requirements of the rules and that boards oversee the valuation designee's and any pricing service's role in fair value calculations. Similarly, we believe that any such effects likely will be small to the extent that UITs currently have in place fair value practices that are generally similar to the requirements of the final rule and that UITs' trustee or depositor oversees the fair value process and any pricing service's role in fair value calculations.

As discussed above, the final rule includes a definition of readily available market quotations and this definition may affect the ability of funds to cross trade certain investments.[617] Any such reduction in cross trades may have some implications for efficiency, competition, and capital formation. Any reduction in the extent of cross trades, to the extent that such trades are executed in the market, may affect market efficiency by contributing to price discovery for such investments that otherwise would not have gone to market. In this regard, transactions that are brought to market rather than being transacted internally will contribute to an increase in more efficient capital allocation and foster capital formation by subjecting more investments to price discovery.

One commenter stated that the requirements of the proposed rule for all investments without readily available market quotations could discourage the purchase of certain securities, particularly for smaller and mid-sized firms and could "impair the ability of such firms to offer funds that invest in fixed income securities, resulting in fewer investment options for mutual fund investors."[618] To the extent that the final rule increases compliance burdens with respect to

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616 *See* Davidson Comment Letter.

617 *See supra* section III.D.4.

618 *See* Guggenheim Comment Letter. The commenter's concern was focused on investments that rely on prices provided by pricing services, particularly those which "frequently use Level 2 inputs."

securities valued with level 2 or level 3 inputs, the final rule could provide incremental disincentives to purchase these securities, particularly by smaller and mid-sized funds. To the extent that these disincentives affect smaller and mid-sized funds more than other funds, the requirements of the final rule may affect the competitive landscape (*e.g.*, by resulting in fewer investment options for investors). However, it is our understanding that the requirements of the final rule align with current practice of fair value determinations of investments without readily available market quotations.

Overall, we do not believe that the rules will have any material effects on competition because the effects of the rules likely will be limited to the extent that the rules are similar to current practices. Even though costs could be more burdensome for smaller fund complexes, we believe that these costs will not significantly affect competition in the fund industry because few funds will incur costs at the higher end of the cost range estimate (*i.e.*, between $100,000 and $600,000). Furthermore, the extent to which the costs of the requirements of the final rule are relatively more burdensome for a fund is likely to be correlated to the fund's current lack of appropriate oversight of the fair value process. As the requirements of the final rule establish a framework for appropriate oversight of the fair value process, this may improve the competitive landscape in the fund industry. Any decrease in the ability of certain funds' engagement in cross trades due to the definition of readily available market quotations and the requirement to fair value all investments that are valued using level 2 inputs should affect all such funds and not result in any change in the competitive landscape in this regard; at most it would level the playing field among funds and thus contribute to a fairer competitive landscape. Thus, we continue to believe that the rules will not negatively affect competition in the fund industry, though it may have unfavorable effects on funds and valuation designees currently lacking an effective framework for appropriate oversight of their fair value processes.

In addition, the requirement of the final rule reasonably to segregate fair value determinations from portfolio management likely will more significantly affect those smaller

valuation designees or funds that lack the staff and resources necessary to effect such segregation as efficiently as larger advisers or larger funds. For example, such funds or valuation designees that lack the staff or resources to effect such segregation may hire additional personnel to ensure (or to assure a board) that they can reasonably segregate the fair value process from portfolio management. Similarly, the requirement to segregate determinations of fair value from portfolio management may present a barrier to entry to smaller advisers. This barrier may be realized through boards' unwillingness to hire advisers that cannot ensure such segregation to the boards' satisfaction. To the extent that boards may be unwilling to hire advisers who cannot reasonably segregate these functions, small advisers without the resources to provide such segregation will face a competitive disadvantage. Nevertheless, we do not believe that this requirement of the final rule will have a material effect on competition in the fund adviser industry because many smaller advisers to funds and internally managed funds currently have in place processes to address the potential conflicts of interest whenever portfolio management personnel provide input to valuation. To the extent that boards currently consider such risks and the need to segregate such functions in their selection of advisers—including small advisers—as we understand is current practice, the requirement is unlikely to affect competition in the fund adviser industry.

Another commenter suggested that one of the valuation risk factors discussed above—"reliance on service providers that have more limited expertise in relevant asset classes"—could "deter competition in the market for pricing services."[619] We do not believe evaluation of valuation risks will prevent funds from engaging a pricing service with limited experience, but rather funds will assess the risks associated with such an engagement and manage them accordingly (for example, through more frequent backtesting of such pricing service's valuation information until it gains more experience).

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619 *See* IHS Markit Comment Letter.

As described above, the requirements of rule 2a-5 are similar to current practices[620] and establish a certain minimum, consistent framework for determinations of fair value in good faith under the final rule.[621] Likewise, rule 31a-4 is based upon current practices and is designed to help implement this framework. Rule 2a-5's framework includes elements providing for effective oversight. Effective corporate governance is a key piece of investor protection[622] at the same that it can provide for increased efficiency, competition, and capital formation. Boards practicing good governance can mitigate the agency problem that exists between the "agents" (*e.g.*, advisers) and the "principals" (*e.g.*, funds). In the area of fair value determinations in good faith, governance can reduce the information asymmetry that exists between fund advisers or portfolio managers and investors.

As described above,[623] we expect that the requirements of the rules will contribute to less biased valuations, which has benefits for fund managers and investors alike. Fund managers are better able to manage their portfolios to tailor their portfolios to specific risk-reward profiles or benchmarks as described in their investment policy statement[624] and to ensure that their portfolios comply with the fund's risk appetite statement. However, advisers may have an incentive to "improperly value fund assets in order to increase fees, improve or smooth returns, or comply with the fund's investment policies and restrictions,"[625] and fund boards are "uniquely positioned to engage in oversight of the affiliated service provider generally and with respect to the conflicts of interest potentially arising in connection with the fair valuation process."[626]

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620 *See supra* section III.B.2.

621 *See supra* section III.C.3 and sections III.D.1 to III.D.4.

622 *See, e.g.*, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Schleifer, & Robert Vishny, *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000).

623 *See supra* footnote 510 and accompanying discussion.

624 *See Elements of an Investment Policy Statement for Institutional Investors*, CFA Institute (2010).

625 *See* Proposing Release, *supra* footnote 2, at n.911 and accompanying text.

626 Russell Comment Letter; *see also* Better Markets Comment Letter; CFA Institute Comment Letter; SIFMA AMG Comment Letter.

Improper and biased valuations may also distort other behavior.[627] The requirements of the final rule are designed to mitigate any such distortions.

Properly valuing a fund's investments is also a critical component of the accounting and financial reporting for investment companies. Appropriate and unbiased valuations should thus provide investors with greater confidence in the accuracy of the value of fund investments, the performance of funds, and the level of risk of fund investments. This should allow investors to evaluate more effectively how a given fund fits their investment objectives, risk appetite, and ability to bear risk.

Taken together, appropriate and unbiased valuation fosters price discovery. Price discovery, in turn, ensures that investments and resources are directed to their most efficient use, both by investors and funds themselves. Efficiency and improved accounting and financial reporting resulting from appropriate and unbiased valuation should promote capital formation by increasing the quality and reliability of information in capital markets.[628] Similarly, appropriate and unbiased valuation induces greater competition as the performance of funds and their advisers becomes more reliably assessable. While appropriate and unbiased valuation contribute to investor protection, efficiency, competition, and capital formation, the extent to which the requirements of the rules will increase these contributions may be limited by the extent to which funds' current practices are similar to the rules. As discussed above, the costs of the rules will likewise be limited to the extent to which funds' current practices are similar to the rules.

F. Reasonable Alternatives

1. Designation to Officers of Internally Managed Fund Not Permitted

We considered not permitting internally managed funds to designate officers to perform the fair value functions required by the final rule, but allowing such funds to seek individual

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627 *See, e.g.*, CFA Institute Comment Letter; Fidelity Comment Letter; JPMAM Comment Letter; MFS Comment Letter; SIFMA AMG Comment Letter; Stradley Comment Letter.

628 *See, e.g.*, Andrea Polo, *Fair Value and Corporate Governance*, 6 CORP. OWNERSHIP & CONTROL 382 (2008).

exemptive applications to allow designation of their officers. This would give the Commission the opportunity to design protections that are more tailored to the kinds and magnitude of conflicts involved in internally managed funds and the kinds of assets in which those funds invest. We believe, however, that the costs to these funds involved in applying for individual exemptive relief could be passed on to investors in these funds. Furthermore, officers of internally managed funds do, in fact, have a fiduciary duty, and play a similar or the same role as other valuation designees. Thus, treating officers of internally managed funds differently or preferentially would be inconsistent with the goal of ensuring appropriate oversight and governance of the fair value process (regardless of the parties involved) that the final rule seeks. Further, we believe that the final rule's oversight and other requirements provide minimum and baseline standards that we believe should be part of any good faith fair value determination for internally managed funds. We do not believe that individually-granted exemptive relief would provide funds or their shareholders substantially more protections in the fair value process, as compared to those included in the final rule, to justify the costs of requiring exemptive applications. For these reasons, we are not adopting this alternative.

2. Safe Harbor

Some commenters suggested that the proposed rule be formulated as a safe harbor.[629] These commenters perceived the proposed rule as prescriptive and indicated that such rules are more appropriate for a safe harbor. Commenters argued that for those not availing themselves of the safe harbor, practices would evolve and adapt in response to market developments and permit heterogeneity of practices that are appropriate for the idiosyncrasies of market participants. However, for those funds that choose not to use the safe harbor, the guidelines would be less clear, and perhaps only as clear the current regulatory framework. Any lack of certainty would

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[629] *See supra* section II; *see also* American Bankers Association Comment Letter; American Funds Trustees Comment Letter; Dechert Comment Letter; Fidelity Trustees Comment Letter; Guggenheim Comment Letter; ICI Comment Letter; Stradley Comment Letter; Vanguard Comment Letter; Comment Letter of Mark Loughridge, Lead Independent Director, Board of Trustees of the Vanguard Funds (July 21, 2020).

likely entail higher compliance costs and possible investor protection costs. Funds not relying on the safe harbor would likely have to divert more resources to ensuring compliance and may fall short of providing appropriate oversight and governance of the fair value process as compared to the final rule. Recasting rule 2a-5 as a safe harbor would not provide a minimum baseline framework, as boards that chose not to avail themselves of the safe harbor might take an approach to the process of making fair value determinations that does not result in investors receiving as rigorous valuations as under the final rule. Valuation is a core responsibility of the board under the Act and critical for investor protection. Consequently, we believe not defining minimum and baseline standards could harm investors if funds took approaches that lacked consistency or certain aspects of these basic standards.

3. Three-Tiered Approach

Some commenters suggested that instead of a binary approach where securities that are valued based on level 2 and level 3 inputs are subject to fair value determinations, we instead adopt a three-tier approach similar to U.S. GAAP's level 1, level 2, and level 3 input classifications and have rules 2a-5 and 31a-4 further distinguish the fair value determination process between securities in level 2 or between level 2 and level 3.[630] We are not adopting this alternative because, as discussed previously, we believe that the Act establishes a binary framework with securities either being valued based on their readily available market quotations, or for all other investments, being fair valued in good faith. However, the final rule establishes a framework that allows boards or valuation designees to tailor their fair value determination process to the investments held by the fund, and allows for a variety of different methodologies to be applied. As described above, the requirements of rule 31a-4 for investments fair valued with level 2 inputs does allow for different levels of recordkeeping that correspond with the risk and nature of the investments that are being fair valued. The recordkeeping and reporting

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630 *See, e.g.*, SSGA Comment Letter.

requirements of rules 2a-5 and 31a-4 are designed to be flexible, and thus funds may distinguish between level 2 and level 3 securities as part of their recordkeeping and reporting processes. Accordingly, we believe that the final rule permits boards and valuation designees sufficient flexibility to design their fair value determination process as appropriate for the investments held by the fund.

4. More Principles-Based Approach

The final rule mandates the performance of certain prescribed functions to determine the fair value of fund investments in good faith. As suggested by many commenters, we considered an alternative with 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 practices, policies and procedures, reporting, and recordkeeping that would allow fair values to be determined in good faith by the board of directors or the valuation designee. For example, funds would have greater discretion to apply more or less rigorous valuation requirements on fair value determinations of investments that rely on level 2 inputs, including treating certain such investments as having readily available market quotations, depending on what the fund deemed to be appropriate.[631]

The benefits of such an approach would be that funds would have more flexibility in what their policies and procedures, reporting, and recordkeeping cover. To the extent this alternative would reduce certainty for funds, it could increase compliance costs to the detriment of fund investors. Further, a less prescriptive approach would not adequately ensure that the board provides sufficient oversight over the valuation designee's fair value determinations.[632] In addition, if certain funds within a fund complex were to use the additional flexibility afforded by

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631 *See supra* section III.B.2.c) and section III.F.3.

632 We acknowledge that under the final rule, funds could face some uncertainty regarding how to comply with the final rule's requirements. Nevertheless, we believe that a more principles-based approach than the final rule would increase further any uncertainty regarding how to comply with the requirements of section 2(a)(41) of the Act without any additional benefit of ensuring appropriate oversight of the fair value process.

a more principles-based approach to set up practices, 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 may not be able to apply a similar framework across the various funds it oversees or because a board believes that the principles-based requirements could be satisfied with respect to a particular fund only using different practices, policies and procedures, reporting, and recordkeeping arrangements. However, such flexibility would provide funds and boards themselves the option to evaluate the tradeoffs among, for example, non-uniform arrangements across funds, more tailored and effective reporting, corresponding increased costs of board oversight, and corresponding increased costs of compliance. Thus each fund could make a choice that is more aligned with its goals and constraints, including regulatory constraints, than under a less principles-based arrangement.

A more principles-based approach would not mandate a minimum, consistent framework for fair value and standard of baseline practices across funds, which we believe is inherent in any good faith fair value determination process. For these reasons, we are not adopting this alternative.

5. Designation of the Performance of Fair Value Determinations to Service Providers Other Than Advisers, Officers, Trustees, or Depositors

Under the final rule, the board may designate the adviser of the fund, or an officer or officers of an internally managed fund, to perform fair value determinations. For UITs, trustees or depositors of a UIT or other entities appointed by existing UITs will perform fair value determinations. The valuation designee carries out all of the functions required under the final rule. As an alternative, we considered allowing the board to designate sub-advisers or service providers other than the adviser or an officer or officers, and providing for parties other than trustees or depositors of a UIT, such as a pricing service, to perform fair value determinations. Such an approach would provide additional flexibility to the board. As noted by commenters, pricing service providers currently provide evaluated prices extensively to funds, many of which

use these prices as fair values for the purposes of the Act.[633] This could also help in a situation where the adviser's conflicts and a pricing service's comparative expertise make designation of the adviser less desirable and designation of the pricing service more beneficial. Likewise, the board might also choose to designate to a party such as a pricing service because the board assesses that the conflicts of interest with the pricing service are less extensive, less problematic, or more feasibly managed than those with an adviser or officers of the fund.

Nevertheless, such an approach potentially could limit a board's ability to oversee effectively the service provider that performs the fair value determinations to the extent that the board does not have the same level of visibility, access to information, and control over the actions of service providers other than the valuation designee as provided in the final rule. Further, even though service providers may have a contractual obligation to perform valuation services for the fund, those service providers may not owe the same fiduciary duty to the fund that an adviser would, and thus their obligation to serve the fund's best interests may be more limited than the adviser's. We also believe, as discussed above, that it is important for the valuation designee to have a direct relationship with the fund's board and have comprehensive and direct knowledge of the fund.[634] Although the final rule allows some persons besides advisers to perform fair value determinations (*e.g.*, officers of internally managed funds and trustees and depositors of UITs) who also generally have a fiduciary duty, we believe that retaining responsibility with a more closely associated person is more likely to increase accountability than a third-party service provider. Hence, such an alternative approach could compromise the integrity of the fair values by increasing the likelihood of conflicts with the adviser.

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633 *See supra* footnote 417 and accompanying discussion.

634 *See supra* footnotes 157 - 158 and accompanying text.

While some pricing services are also registered investment advisers, such pricing services would not necessarily owe the same fiduciary duties to a fund if they are not the investment adviser for the fund, and may have conflicts of interest that are more difficult to mitigate to the extent that the role of fair value determination and portfolio management are integrated. Further, in cases where a single pricing service cannot perform fair value determinations for all assets, the process and oversight could become extremely burdensome for funds and their boards. Finally, nothing in the final rule prevents other service providers, such as pricing services, from continuing to provide significant input and assistance, much as they do today, on fair value determinations. However, retaining direct responsibility with an adviser or more closely affiliated designee is more likely to increase accountability and oversight over these other service providers.

6. Not Permit Boards to Designate a Valuation Designee

As discussed in more detail above, unlike the current regulatory framework, the final rule permits fund boards to designate the performance of fair value determinations to a valuation designee. In addition, relative to the current regulatory framework, rules 2a-5 and 31a-4 will mandate more specific fair value practices, reporting, and recordkeeping. As an alternative to these rule, we considered not permitting fund boards to designate a valuation designee to perform fair value determinations for the fund but instead only requiring funds to adopt the practices, reporting, and recordkeeping as described in the final rule. We also considered requiring boards periodically to ratify the fair value determinations calculated by the fund's valuation designee using a methodology determined by the board. Such an approach could prescribe minimum requirements with respect to valuation practices, reporting, and recordkeeping. Nevertheless, such an approach would not allow funds the flexibility to leverage the fair value expertise of the valuation designee and assign a role to the fund's board that is more in line with the board's experience and expertise. Consequently, 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, nor would it ultimately benefit fund investors.

IV. PAPERWORK REDUCTION ACT

A. Introduction

Certain provisions of rules 2a-5 and 31a-4 contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[635] We are submitting the collections of information to the Office of Management and Budget ("OMB") for review in accordance with the PRA.[636] The title for the existing collection of information is "Investment Company Act Rule 38a-1, 17 C.F.R. 270.38a-1, Compliance procedures and practices of registered investment companies" (OMB Control No. 3235-0586). We are also submitting a new collection of information for rules 2a-5 and 31a-4. The titles for the new collections of information will be "Rule 2a-5 under the Investment Company Act of 1940, Fair Value" and "Rule 31a-4 under the Investment Company Act of 1940, Records of Fair Value Determinations." 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.

We discuss below the collection of information burdens associated with new rules 2a-5, 31a-4, and their impact on the burdens of rule 38a-1.[637] Rule 2a-5 will provide requirements for determining fair value in good faith for purposes of section 2(a)(41) and rule 2a-4 thereunder and rule 31a-4 will provide the recordkeeping requirements associated with this rule.

B. Rule 2a-5

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635 44 U.S.C. 3501 through 3520.

636 44 U.S.C. 3507(d); 5 CFR 1320.11

637 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 for professional staff and 2.93 for clerical staff 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").

Rule 2a-5 will provide requirements for determining fair value in good faith for purposes of section 2(a)(41) and rule 2a-4 thereunder. This determination will involve assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; and evaluating any pricing services used. The final rule will permit a fund's board of directors to designate the performance of fair value determinations relating to any or all fund investments to a valuation designee, which will carry out all of these requirements, subject to board oversight and certain reporting and other requirements designed to facilitate the board's ability effectively to oversee the valuation designee's fair value determinations. As relevant here, the final rule will require, if the board designates performance of fair value determinations to a valuation designee, that the valuation designee report to the board in both periodic and as needed reports on a per-fund basis.[638]

The respondents to rule 2a-5 will be registered investment companies and BDCs.[639] We estimate that 9,804 funds will be affected by rule 2a-5, of which 9,335 are not UITs.[640] Compliance with rule 2a-5 will be mandatory for any fund that will need to determine fair value under the Act. To the extent that records will be required to be created and maintained under the final rule are provided to the Commission in connection with examinations or investigations, such information will be kept confidential subject to the provisions of applicable law.

Table 3 below summarizes the PRA initial and ongoing burden estimates associated with the board reporting requirements under the final rule, as well as the proposed burden estimates. Some commenters argued that the burden estimates as proposed for this requirement were too low, arguing in particular that the cost to produce the items that would have been required on a quarterly basis as part of the proposed periodic reporting requirements would be in excess of what we had assumed due to burdens of both creating these reports and of reviewing them on the

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638 Rule 2a-5(b).

639 *See* Rule 2a-5(e)(1) (defining "fund").

640 *See supra* footnotes 508 - 509 and accompanying text.

part of the board.[641] While we have clarified that certain reporting that commenters thought was suggested in the proposed rule will not be required in the final rule and made other changes to address these concerns,[642] we are nonetheless increasing our estimates for the final rule in consideration of these comments. We also have corrected certain estimates, specifically to include an initial burden as we believe the final rule will impose some start-up burdens and to update the wage rates for relevant personnel. We have also updated the estimated number of respondents based upon updated data.[643] Lastly, we increased the estimated amount of external cost burden to include costs relating to both legal and accounting services as the proposed estimate only estimated external costs relating to legal expenses.

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641 *See* Sullivan Comment Letter; TRP Comment Letter; SIFMA AMG Comment Letter; American Trustees Comment Letter; *see also* Capital Group Comment Letter; Guggenheim Trustees Comment Letter.

642 *See supra* section II.B.2.

643 *See supra* footnotes 508 - 509 and accompanying text.

Table 3: Rule 2a-5 PRA Estimates

	Initial internal burden hours	Internal annual burden hours[1]		Wage rate[2]	Internal time costs	Initial external cost burden	Annual external cost burden
PROPOSED ESTIMATES							
Adviser written reports	0 hours	8 hours	×	$329 (senior manager)	$2,632	$2,000	$2,000
	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	$2,000
Number of funds		× 9,501			× 9,501	× 9,501	× 9,501
Total proposed burden		**95,010 hours**			**$198,162,357**	**$19,002,000**	**$19,002,000**
FINAL ESTIMATES							
Valuation designee written reports	**12 hours**	**24 hours**	**×**	$368 (senior operations manager)	**$8,832**	**$3,180**	**$3,180**
	1.5 hours	**2 hours**	**×**	$4,770 (directors)[3]	**$9,540**		
	6 hours	**8 hours**	**×**	$368 (compliance attorney)	**$2,944**		
Total annual burden per fund		**34 hours**			**$21,316**	**$3,180**	**$3,180**
Number of funds		× 9,335			× 9,335	× 9,335	× 9,335
Total final burden		**317,390 hours**			**$198,984,860**	**$29,685,300**	**$29,685,300**
TOTAL ESTIMATED BURDENS FOR BOARD REPORTING							
Proposed burden estimates		**95,010 hours**			**$198,162,357**	**$19,002,000**	**$19,002,000**
Proposed total respondents		**9,501**					
Revised burden estimates		**317,390 hours**			**$198,984,860**	**$29,685,300**	**$29,685,300**
Revised total respondents		**9,335**					

Notes:
1. These estimates include initial burden estimates annualized over three years.
2. *See* SIFMA Report, *supra* footnote 639.
3. This wage rate is not from the SIFMA Report but is a staff estimate. It is a combined cost for the entire board (not a per board member cost). This estimate assumes an average of 9 board members per board.
4. This estimated burden is based on the estimated wage rate of $489/hour, for 4 hours, for outside legal services and of $306/hour, for 4 hours, for outside accounting services. *See supra* footnote 639.

C. Rule 31a-4

Rule 31a-4 contains the recordkeeping requirements associated with rule 2a-5. Specifically, registered investment companies and BDCs, or their advisers, will be required to maintain appropriate documentation to support fair value determinations made pursuant to rule 2a-5.[644] Further, if the board of the fund designates performance of fair value determinations to a valuation designee under the final rule, the fund or adviser will need to maintain certain additional records relating to that designation.[645] The respondents to rule 31a-4 will be registered investment companies and BDCs.[646] We estimate that 9,804 funds will be affected by rule 31a-4.[647] Compliance with rule 31a-4 will be mandatory for any fund that will need to determine fair value under the Act. To the extent that records that will be required to be created and maintained under this rule are provided to the Commission in connection with examinations or investigations, such information will be kept confidential subject to the provisions of applicable law.

Table 4 below summarizes the PRA initial and ongoing burden estimates associated with the rule, as well as the proposed burden estimates. Some commenters argued that the burden estimates as proposed for this requirement were too low.[648] Specifically, these commenters stated that the proposed requirement to maintain documentation to support fair value determinations, including information regarding the specific methodologies applied and the assumptions and inputs considered when making fair value determinations, would result in the valuation designee needing to obtain significant amounts of data that it would not otherwise obtain and retain it

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644 Rule 31a-4(a).

645 Rule 31a-4(b).

646 *See* Rule 2a-5(e)(1) (defining "fund").

647 *See supra* footnotes 508 - 509 and accompanying text.

648 *See, e.g.,* ICI Comment Letter; Fidelity Comment Letter; Vanguard Comment Letter; Guggenheim Comment Letter; Guggenheim Trustees Comment Letter. *But see* Davidson Comment Letter (suggesting that the Commission provided ample reason to believe that the costs of compliance would be on the smaller side).

when it utilizes a pricing service,[649] and would require funds or valuation designees to hire additional personnel to be able to comply.[650] While we have clarified that certain recordkeeping that commenters thought was suggested in the proposed rule will not be required in rule 31a-4 as adopted and made other changes to address these concerns,[651] we are nonetheless significantly increasing our estimates for this rule in consideration of these comments. We have also updated the estimated number of respondents based upon updated data.[652] We also further revised certain estimates, specifically to include the likely involvement of a compliance attorney in the formulation of policies and procedures relating to this requirement and to update the wage rates for relevant personnel.

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649 *See, e.g.,* ICI Comment Letter; IDC Comment Letter; SSGA Comment Letter; Fidelity Comment Letter; TRP Comment Letter; John Hancock Comment Letter; ICE Data Comment Letter (noting that pricing services would need to increase fees to compensate for the demands for records under the proposed regime).

650 *See* Guggenheim Trustees Letter; Guggenheim Comment Letter.

651 *See supra* section II.C.

652 *See supra* footnotes 508 - 509 and accompanying text.

Table 4: Rule 31a-4 PRA Estimates

	Initial internal 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 hours	0.5 hours	×	$62 (general clerk)	$62	$1,800	$600
	1.5 hours	0.5 hours	×	$95 (senior computer operator)	$95		
Recordkeeping	0 hours	2 hours	×	$62 (general clerk)	$124	$0	$0
	0 hours	2 hours	×	$95 (senior computer operator)	$190		
Total annual burden per fund		**5 hours**			**$471**	**$1,800**	**$600**
Number of funds		× 9,986			× 9,986	x 9,986	x 9,986
Total proposed annual burden		**49,930 hours**			**$4,703,406[3]**	**$17,974,800[4]**	**$5,991,600**
FINAL ESTIMATES							
Establishing recordkeeping policies and procedures[5]	**0 hours**	0 hours	×	N/A	$0	$0	$0
Recordkeeping	**6 hours**	18 hours	×	$63 (general clerk)	$1,134	$0	$0
	6 hours	18 hours	×	$96 (senior computer operator)	$1,728		
	6 hours	18 hours	×	$368 (compliance attorney)	$6,624		
Total annual burden per fund		**54 hours**			**$9,486**	**$0**	**$0**
Number of funds		× 9,804			× 9,804		
Total final annual burden		**529,416 hours**			**$93,000,744**	**$0**	**$0**
TOTAL ESTIMATED BURDENS FOR BOARD REPORTING							
Proposed burden estimates		**49,930 hours**			**$4,703,406**	**$17,974,800**	**$5,991,600**
Proposed total respondents		**9,986**					
Revised burden estimates		**529,416 hours**			**$93,000,744**	**$0**	**$0**
Revised total respondents		**9,804**					

Notes:

1. These estimates include initial burden estimates annualized over a three-year period.

2. *See* SIFMA Report, *supra* footnote 639.
3. Due to a math error, these costs were erroneously reported as $1,567,802 in the Proposing Release.
4. The total initial external cost burden was not calculated in the Proposing Release.
5. We are now accounting for the burdens associated with the policies and procedures aspect of this rule as part of our burden estimates relating to rule 38a-1. *See supra* section IV.D.

D. Rule 38a-1

As discussed above, after our adoption of rules 2a-5 and 31a-4, rule 38a-1 will require the adoption and implementation of written policies and procedures reasonably designed to prevent violations of the requirements of the rules.[653] To comply with rule 38a-1, these policies and procedures must be tailored to rules 2a-5 and 31a-4's requirements to ensure that a board or valuation designee, as applicable, determines the fair value of fund investments in compliance with the rules. In our most recent PRA submission for rule 38a-1, we estimated for rule 38a-1 a total hour burden of 235,720 hours, at a time cost of $86,784,720, and no external burdens.[654]

The table below summarizes the PRA initial and ongoing burden estimates associated with the new fair value policies and procedures.

Table 5: Rule 38a-1 PRA Estimates

	Internal initial burden hours	Internal annual burden hours		Wage rate[1]	Internal time costs	Initial external cost burden	Annual external cost burden
FINAL ESTIMATES							
Establishing and implementing new 38a-1 fair value policies and procedures	6 hours	4 hours[2]	x	$329 (senior manager)	$1,316.00	$3,000.00	$1,000.00
	6 hours	4 hours[2]	x	$466 (ass't general counsel)	$1,864.00		
	3 hours	2 hours[3]	x	$530 (chief compliance officer)	$1,060.00		
	3 hours	2 hours[3]	x	$365 (compliance attorney)	$730.00		
	3 hours	2 hours[3]		$4,770 (Board of Directors as a whole)[4]	$9,540		
Reviewing and updating 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		
		1 hour	X	$4,770 (Board of Directors as a whole)[4]	$4,770.00		

653 *See supra* section II.A.5.

654 This estimate is based on the last time the rule's information collection was submitted for PRA renewal in 2020.

Total annual burden per fund	22 hours	$22,195.00		$2,000.00
Number of affected funds	× 9,804	× 9,804	× 9,804	× 9,804
Total annual burden	**215,688 hours**	**$217,599,780**	**$29,412,000**	**$19,608,000**
TOTAL ESTIMATED BURDENS FOR RULE 38a-1				
Current burden estimates	**235,720 hours**	**$86,784,720**	**$0**	**$0**
Revised burden estimates	**451,408 hours**	**$304,384,500**	**$29,412,000**	**$19,608,000**

Notes:
1. Wage rates 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 ("SIFMA Report"), modified by Commission staff to account for an 1800-hour work year and inflation, and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.
2. Includes initial burden estimates annualized over a three-year period, plus 2 hours of ongoing annual burden hours.
3. Includes initial burden estimates annualized over a three-year period, plus 1 hour of ongoing annual burden hours.
4. The estimate for the cost of board time as a whole is derived from estimates made by the staff regarding typical board size and compensation, based on information received from fund representatives and publicly available sources.

V. FINAL REGULATORY FLEXIBILITY ANALYSIS

The Commission has prepared the following Final Regulatory Flexibility Analysis ("FRFA") in accordance with section 604 of the Regulatory Flexibility Act ("RFA").[655] It relates to new rules 2a-5 and 31a-4. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with the RFA and included in the Proposing Release.[656]

A. Need for the Rules

The Commission is adopting 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 the fund. The Commission is also adopting rule 31a-4 to address the recordkeeping requirements associated with rule 2a-5. 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. Rule 2a-5 is designed to specify how a board or valuation designee, as applicable, must make good faith determinations of fair value as well as when the board can designate the performance of these determinations to a

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655 5 U.S.C. 604.

656 *See* Proposing Release, *supra* footnote 2, at section V.

valuation designee, while still ensuring that fund investments are valued in a way consistent with the Investment Company Act.[657]

Rule 2a-5 will 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 will be required to involve: assessing and managing material risks associated with fair value determinations; selecting, applying, and testing fair value methodologies; evaluating any pricing services used; and maintaining certain records required by rule 31a-4.[658] The rules will permit a fund's board of directors to designate the performance of these requirements to a valuation designee 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 valuation designee's fair value determinations.[659] Rule 2a-5 will also define when market quotations are readily available under section 2(a)(41) of the Act. Lastly, rule 2a-5 will have the trustee or depositor of a UIT (or in the case of existing UITs another entity designated to do so in the UIT's documentation) carry out the requirements of the rules. The requirements of rule 2a-5 associated with the fair value as determined in good faith and readily available market quotations are designed to create a minimum, consistent framework for fair value and standard of baseline practices across funds, and reflects our understanding of current market practices.[660] The requirements of rule 2a-5 associated with the designation of the performance of responsibilities to a valuation designee are designed to ensure that the board effectively oversees such valuation

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657 Under the final rule, the valuation designee must be a fund's adviser or, if the fund is internally managed, an officer of the fund. The trustee or depositor of a UIT (or in the case of existing UITs another entity designated to do so in the UIT's documentation), which does not have a board, will perform fair value determinations

658 As a result of the adoption of rule 2a-5, under rule 38a-1 funds or the adviser must adopt and implement policies and procedures reasonably designed to comply with rule 2a-5.

659 For internally managed funds, the board may designate an officer or officers of the fund to perform fair value determinations.

660 *See supra* sections I, II.A, and II.D.

designee, including receiving sufficient information to do so.[661] The recordkeeping requirements of rule 31a-4 are designed to help ensure compliance with the other requirements.[662]

All of these requirements are discussed in detail in section II of this release. The costs and burdens of these requirements on small funds 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.[663]

B. Significant Issues Raised by Public Comments

In the Proposing Release, we requested comment on every aspect of the IRFA, including the number of small entities that would be affected by the proposed rule, the existence or nature of the potential impact of the proposal on small entities discussed in the analysis, and how to quantify the impact of the proposed rule. We also requested comment on the proposed compliance burdens and the effect these burdens would have on smaller entities.

Although we did not receive comments specifically addressing the IRFA, some commenters noted the impact of certain aspects of proposed rule 2a-5 on smaller funds. For example, one commenter suggested that we allow funds to assign fair value determinations to entities other than the adviser, such as the fund's administrator, to make it easier for smaller funds to comply with the proposed rule.[664] Another commenter argued that we should adopt a more principles-based approach that would be less burdensome on smaller funds.[665] Additionally, a few commenters stated that the proposed quarterly reporting requirement would be unnecessarily burdensome, including for smaller funds, because many of the valuation issues

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661 *See supra* section II.B.

662 *See supra* sections II.A.5 II.C.

663 *See supra* section III and IV. These sections also discuss the professional skills that we believe compliance with the rules will entail.

664 IDC Comment Letter.

665 ABA Comment Letter.

described in the Proposing Release are unlikely to change on a quarterly basis.[666] Furthermore, with regard to the requirement that certain valuation issues be reported promptly to the fund's board, one commenter suggested that we allow one of the independent directors on the board to receive these reports to make the requirement less burdensome for small funds.[667] Finally, one commenter suggested that the recordkeeping requirements of the proposed rule 2a-5 was duplicative with the section 31 rules.[668] After considering the comments we received, we are adopting the rules, with certain modifications from the proposal intended to address many of the challenges commenters identified.

As discussed above, we believe that it is important to establish a minimum and consistent framework for fair value practices across funds, including for small funds.[669] Therefore, rule 2a-5 establishes requirements for engaging in fair value determinations that are broadly applicable to all funds, including small funds, and that we believe should be part of any good faith fair value determination. However, we have made certain modifications to the requirements of the proposed rule to enhance flexibility and ease certain unnecessary burdens. For example, we have made certain changes to the proposed quarterly reporting requirements designed to enhance flexibility of reporting to match boards' needs better and to minimize the chance that boards receive reporting that is too detailed or repetitive to facilitate appropriate oversight.[670] Additionally, in a change from the proposal, which would have permitted boards to assign only to an adviser of the fund, rule 2a-5 will permit boards to designate the fund's adviser to perform fair value determinations or, if the fund is internally managed, an officer of the fund.

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666 Sullivan Comment Letter. *See also* ICI Comment Letter.

667 Murphy Comment Letter

668 NYC Bar Comment Letter.

669 *See supra* text accompanying footnote 13

670 *See supra* section II.B.2 (noting that the final rule will require a quarterly summary or description of material fair value matters that occurred in the prior quarter while the annual report will include an assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of designated investments);

Furthermore, rule 2a-5 clarifies, in response to commenters,[671] that the board or the valuation designee can seek the assistance of other parties that provide services that are essential for fair value determination, such as a pricing service or the fund administrator, among others. Finally, new rule 31a-4 contains the recordkeeping requirements associated with rule 2a-5. We believe that these modifications will make it less burdensome for small funds to comply with the rules, while still maintaining the integrity of the fair value process across all funds.

C. Small Entities Subject to the Rule

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").[672] Commission staff estimates that, as of June 2020, approximately 40 registered open-end mutual funds,[673] 8 registered ETFs, 26 registered closed-end funds,[674] 2 UITs, and 12 BDCs[675] (collectively, 88 funds) are small entities.[676]

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The rules will require fair value determinations under the Act to be made according to a specific process for affected funds, including those that are small entities. This process will include a requirement to maintain certain records to support fair value determinations.[677] The rules will permit fund boards to designate the valuation designee to perform fair value determinations if the valuation designee, in addition to the above, makes certain reports to the

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671 Sullivan Comment Letter.

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

673 None of these registered open-end funds are internally managed.

674 7 of these registered closed-end funds are internally managed.

675 3 of these BDCs are internally managed.

676 This estimate is derived an analysis of data obtained from Morningstar Direct as well as data reported to the Commission for the period ending June 2020.

677 As discussed above, after our adoption of rule 2a-5, pursuant to rule 38a-1 funds should adopt and implement written fair value policies and procedures reasonably designed to prevent violations of rule 2a-5. *See supra* section II.A.5.

fund's board regarding the fair value process in writing. Funds will also be required to keep certain additional records in such circumstances. We therefore believe that there are two principal reporting, recordkeeping, or other compliance requirements associated with the rules: (1) recordkeeping requirements and (2) board reporting requirements.

1. Recordkeeping

The recordkeeping requirements of rule 31a-4 are designed to help ensure compliance with rule 2a-5's requirements and aid in oversight. Rule 31a-4 will require the fund to keep appropriate documentation to support fair value determinations for at least six years from the time the determination was made, the first two years in an easily accessible place.[678] Further, should the board designate the valuation designee to perform fair value determinations, the fund must keep, in addition to the records above, copies of the reports and other information provided to the board for at least six 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 designated to the valuation designee, in each case for at least six years after the end of the fiscal year in which the determinations were provided to the board or the investments or investment types were designated to the valuation designee, the first two years in an accessible place.[679]

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.[680] 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

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678 Rule 31a-4(a). Rule 38a-1 also will require funds to keep 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.

679 Rule 31a-4(b).

680 *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.

that are not part of a fund complex – may not have recordkeeping systems that meet all the elements that are required under this rule. Also, while larger funds or funds that are part of a large fund complex may incur higher costs related to these requirements in absolute terms relative to a smaller fund or a fund that is part of a smaller fund complex, a smaller fund may find it more costly, per dollar managed, to comply with the requirements because it will not be able to benefit from a larger fund complex's economies of scale.[681]

2. Board Reporting

The requirement for board reporting by the valuation designee is designed to ensure that the board can exercise sufficient oversight over the fair value process. The final rule will require two general types of reports, periodic reports and prompt reports. Periodic reports rule will require the valuation designee to make both annual and quarterly written reports to the board. The quarterly reports must include any specific reports or materials boards request related to the fair value of designated investments or the valuation designee's process for fair valuing fund investments. In addition, the final rule requires a quarterly summary or description of material fair value matters that occurred in the prior quarter, including some specific summaries and descriptions. The final rule will also require an annual assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of designated investments. The prompt reporting requirement will require the valuation designee to provide a written notification of the occurrence of matters associated with the valuation designee's process that materially affect the fair value of the designated portfolio of investments (defined as "material matters") within a time period determined by the board, but in no event later than five business days after the valuation designee becomes aware of the material matter. Material matters in this instance include an assessment of a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process or of

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681 *See supra* section III.E.

material errors in the calculation of net asset value. The valuation designee must also provide such timely follow-on reports as the board may reasonably determine appropriate.[682]

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.[683] There are different factors that will 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, 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 meets all the elements that will be required under the final rule. Also, while larger funds or funds that are part of a large fund complex may incur higher costs, via increased advisory fees for valuation designees 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, a smaller fund may find it more costly, per dollar managed, to comply with the final requirement because it will not be able to benefit from a larger fund complex's economies of scale.[684]

E. Agency Action to Minimize Effect on Small Entities

The RFA 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

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682 *See supra* section II.B.2.

683 *See supra* section III.C.3 and section IV.

684 *See supra* section III.C.1.

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 the rules would permit us to achieve our stated objectives, principally to protect investors from improper valuations. Further, the board reporting and additional recordkeeping provisions of the rules only affect fund boards that designate a valuation designee to perform fair value determinations, and, therefore, the rules will require funds to comply with these specific requirements only if the boards designated responsibilities to a valuation designee. 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 these provisions of the rules.

We estimate that 72% of all funds will be subject to the rules in making fair value determinations.[685] This estimate indicates that some funds, including some small funds, will be unaffected by the rules. However, for small funds that are affected by the rules, providing an exemption for them could subject investors in small funds to a higher degree of risk than investors in large funds that will be required to comply with the elements of the rules.

As discussed throughout this release, we believe that the rules will 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 rules' 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 elements of the rules 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.

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[685] *See supra* footnote 508 and accompanying text.

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 rules 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.

We do not believe that clarifying, consolidating, or simplifying the requirements under the rules for small funds, beyond that already adopted 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 rules and the guidance contained in this release, that the requirements of the rules are, to some extent, current industry practice under existing rules, with some changes from current practice. As a result, we think that the rules could result in a reduction in the current burdens experienced by small entities to the extent that they are subject to the rules.

The costs associated with rules 2a-5 and 31a-4 will vary depending on a fund's particular circumstances, and thus the rules could result in different burdens on funds' resources. In particular, we expect that a fund that does not have reporting or recordkeeping practices similar to those that will required by the rules 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 rules, we believe it will incur relatively low costs to comply with it. However, we believe that it is appropriate to correlate the costs associated with the rules 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 rules generally use design standards for all funds subject to the rules, regardless of size. We believe that providing funds with the flexibility permitted in the rules with respect to designing specific fair value process is appropriate because of the fact-specific nature of making fair value

determinations.

VI. UPDATE TO CODIFICATION OF FINANCIAL REPORTING POLICIES

The Commission amends the "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1 (April 15, 1982) [47 FR 21028 (May 17, 1982]) as follows:

1. By removing and reserving Section 404.03.

2. By removing and reserving Section 404.04.

3. By amending Section 404.05.c.2. as follows:

a. By removing the last paragraph under the subject heading "Fair Value for Thinly Traded Securities."

b. By removing the subject heading "Use of Pricing Services" and the paragraphs included below that subject heading.

The Codification is a separate publication of the Commission. It will not be published in the Federal Register or Code of Federal Regulations. For more information on the Codification of Financial Reporting Policies, contact the Commission's Public Reference Room at (202) 551-5450.

STATUTORY AUTHORITY

The Commission is adopting rules 2a-5 and 31a-4 under the authority set forth in sections 2(a), 6(c), 31(a), 31(c), 38(a), 59, and 64(a) of the Investment Company Act of 1940 [15 U.S.C. 80a-2(a), 80a-6(c), 80a-30(a), 80a-31(c), 80a-37(a), 80a-58, and 80a-63(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.

TEXT OF RULE AMENDMENTS

For the reasons set out in the preamble, we are amending title 17, chapter II of the Code of Federal Regulation 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 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. Amend § 210.6-03 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 subsection 1, 2, 3, and 9 or the aggregate cost of each category of investment reported under § 210.6-05 subsection 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.

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

3. The general authority citation for part 270 continues to read 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. Add § 270.2a-5 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, provided that a selected methodology may be changed if a different methodology is equally or more representative of the fair value of fund investments, including specifying the key inputs and assumptions specific to each asset class or portfolio holding;

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

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

(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 to be used; and

(4) *Evaluate pricing services*. Overseeing pricing service providers, if used, including establishing the process for approving, monitoring, and evaluating each pricing service provider and initiating price challenges as appropriate.

(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 designate the valuation designee to perform the fair value determination relating to any or all fund investments, which shall carry out all of the functions required in paragraph (a) of this section, subject to the requirements of this paragraph (b).

(1) *Oversight and reporting.* The board oversees the valuation designee, and the valuation designee 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*. (A) At least quarterly:

(*1*) Any reports or materials requested by the board related to the fair value of designated investments or the valuation designee's process for fair valuing fund investments; and

(*2*) A summary or description of material fair value matters that occurred in the prior quarter, including:

(*i*) Any material changes in the assessment and management of valuation risks required under paragraph (a)(1) of this section, including any material changes in conflicts of interest of the valuation designee (and any other service provider);

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

(*iii*) Any material changes to the valuation designee's process for selecting and overseeing pricing services, as well as any material events related to the valuation designee's oversight of pricing services; and

(B) At least annually, an assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of the designated portfolio of investments, including, at a minimum:

(*1*) A summary of the results of the testing of fair value methodologies required under paragraph (a)(3) of this section; and

(*2*) An assessment of the adequacy of resources allocated to the process for determining the fair value of designated 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; and

(ii) *Prompt board notification and reporting.* The valuation designee notifies the board of the occurrence of matters that materially affect the fair value of the designated portfolio of investments, including a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process, or material errors in the calculation of net asset value, (any such matter or error, a "material matter") within a time period determined by the board (but in no event later than five business days after the valuation designee becomes aware of the material matter), with such timely follow-on reporting as the board may determine appropriate; and

(2) *Specify responsibilities*. The valuation designee specifies the titles of the persons responsible for determining the fair value of the designated investments, including by specifying the particular functions for which they are responsible, and reasonably segregates fair value determinations from the portfolio management of the fund such that the portfolio manager(s) may not determine, or effectively determine by exerting substantial influence on, the fair values ascribed to portfolio investments.

(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, and the initial deposit of portfolio securities into the unit investment trust occurs *after* [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], the fund's trustee or depositor

must carry out the requirements of paragraph (a) of this section. If the initial deposit of portfolio securities into the unit investment trust occurred *before* [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], and an entity other than the fund's trustee or depositor has been designated to carry out the fair value determination, that entity 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.

(4) *Valuation designee* means the investment adviser, other than a sub-adviser, of a fund or, if the fund does not have an investment adviser, an officer or officers of the fund.

5. Add § 270.31a-4 to read as follows:

§ 270.31a-4 Records to be maintained and preserved by registered investment companies relating to fair value determinations.

(a) *Appropriate documentation*. Every registered investment company shall maintain appropriate documentation to support fair value determinations made pursuant to § 270.2a-5 for at least six years from the time that the determination was made, the first two years in an easily accessible place.

(b) *Records when designating.* If the board of a registered investment company has designated performance of fair value determinations to a valuation designee under § 270.2a-5(b), in addition to the records required in paragraph (a) of this section, the registered investment company must maintain copies of:

(1) The reports and other information provided to the board as required under § 270.2a-5(b)(1) for at least six years after the end of the fiscal year in which the documents were provided to the board, the first two years in an easily accessible place; and

(2) A specified list of the investments or investment types whose fair value determination has been designated to the valuation designee to perform pursuant to § 270.2a-5(b) for a period beginning with the designation and ending at least six years after the end of the fiscal year in which the designation was terminated, in an easily accessible place until two years after such termination.

(c) *Party to maintain.* If the board of a registered investment company has designated performance of fair value determinations to its investment adviser under § 270.2a-5(b), such investment adviser shall maintain the records required by this section. If the investment adviser is not so designated, the fund shall maintain such records.

By the Commission.

Dated: December 3, 2020.

Vanessa A. Countryman,

Secretary.

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