SULLIVAN & CROMWELL LLP

April 29, 2020

SEC Proposes New Rule to Modernize Fund Valuation Framework

Proposed Rule 2a-5 Under the Investment Company Act of 1940 Would Establish Requirements for the Determination of Fair Value for Fund Investments, Codify the Ability of Fund Boards to Assign Fair Value Determinations to a Fund's Investment Adviser and Rescind Certain Existing Guidance

SUMMARY

On April 21, 2020, the Securities and Exchange Commission (the "SEC") voted unanimously to propose Rule 2a-5 (the "Proposed Rule") under the Investment Company Act of 1940 (the "Investment Company Act"), intended to modernize the framework for fund valuation practices and clarify how boards can satisfy their valuation obligations with respect to registered investment companies and business development companies ("funds").[1] The SEC's approach recognizes that most fund boards do not play a day-to-day role in the pricing of fund investments, and would allow a fund's board to assign the determination of fair value to the fund's investment adviser, subject to detailed conditions and oversight requirements.

The Proposed Rule is a significant development and follows substantial outreach regarding fund valuation practices by the SEC's Division of Investment Management pursuant to the staff's previously announced Board Outreach Initiative.[2] The SEC has not comprehensively addressed fund valuation practices since it issued Accounting Series Releases 113 ("ASR 113") and 118 ("ASR 118") in 1969 and 1970, respectively.

This memorandum provides an overview of the Proposed Rule, which would (i) provide requirements for determining fair value in good faith for purposes of section 2(a)(41) of the Investment Company Act, (ii) confirm that a fund's board may make the requisite fair value determinations itself and also permit the board to assign determination of fair value to the fund's investment adviser, subject to certain conditions and oversight requirements, (iii) provide that a market quotation with respect to fund investments 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, and (iv) rescind ASR 113, ASR 118 and other SEC staff guidance on related topics.

The Proposed Rule should generally be well received by fund boards, many of which have already implemented policies or adopted practices that are largely consistent with the requirements of the Proposed Rule. However, commenters may wish to focus on whether, as Commissioner Peirce cautioned, the benefits of the Proposed Rule may be "diminished significantly by an overly prescriptive approach to ensuring adequate board administration of the fair valuation process,"[3] and whether a less prescriptive approach, or modifications to the structure of the rule (e.g., making it a safe harbor rule or addressing the fund valuation framework through formal SEC guidance), would better accommodate the wide variation in funds' operations, investment strategies and practices. In particular, commenters may wish to consider the implications of a rule that expressly delineates minimum conditions for a board of directors to act in "good faith"—the first SEC regulation of which we are aware to do so. Whether or not a board of directors has acted in "good faith" has historically been a facts-and-circumstances determination under state law.

The public comment period for the Proposed Rule will remain open until July 21, 2020.

BACKGROUND

The valuation of a fund's portfolio investments is a critical component of the fund's operations, and affects the fees paid, the returns received and the value of the shares of the fund. Section 22(c) of the Investment Company Act and rule 22c-1 thereunder require registered investment companies that issue redeemable securities to sell and redeem their shares at prices based on the current net asset value ("NAV") of those shares.[4] Although closed-end funds, including business development companies ("BDCs") that are listed on an exchange, are not subject to rules 2a-4 and 22c-1 under the Investment Company Act, section 23(b) of the Investment Company Act limits the ability of closed-end funds to sell shares of their common stock at a price below current NAV.

Pursuant to Section 2(a)(41) of the Investment Company Act and rule 2a-4 thereunder, the valuation of a fund's portfolio securities depends on whether market quotations are "readily available." Where market quotations are readily available, the fund's securities are valued at the current market value of such securities.[5] Where no such market quotations are readily available, the fund's securities are valued at the fair value as determined in good faith by the board of directors.[6]

As the SEC acknowledges, the determination of the fair value of a fund's investments is typically performed by third parties, such as the fund's investment adviser, and most fund boards are not directly involved in the day-to-day aspects of determining valuations. However, historically the SEC has never clearly stated that a fund's board is permitted to assign the responsibility for fair value determinations to its investment adviser, and the related SEC and staff guidance has been ambiguous on this point. For example, the SEC

has stated that a fund's directors "may not delegate to others the ultimate responsibility of determining the fair value of any asset not having a readily ascertainable market value,"[7] while also stating in ASR 118 that a fund's directors "may appoint persons to assist them in the determination of [fair] value, and to make the actual calculations pursuant to the board's direction."[8]

Recognizing the evolution of markets and substantial growth in the fund industry, as well as several significant regulatory developments since the issuance of ASR 113 and ASR 118,[9] the Proposed Rule would codify the approach taken today by many fund boards with respect to valuation by expressly permitting boards to assign the determination of fair value to the fund's investment adviser. Any such assignment would be subject to important conditions and oversight requirements in the Proposed Rule designed to enable the board to satisfy its statutory obligation to determine fair value in good faith through the proposed framework. The Proposed Rule would also acknowledge and reflect a number of other developments in fund investment practices that have occurred since the issuance of ASR 113 and ASR 118, such as the introduction of increasingly complex securities and an increased engagement with third-party pricing services.

SUMMARY OF THE PROPOSED RULE

The Proposed Rule would apply to all registered investment companies and BDCs, regardless of their classification or sub-classification (e.g., both open-end funds and closed-end funds, including BDCs), or their investment objectives or strategies (e.g., equity or fixed income; actively managed or tracking an index).[10]

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

The Proposed Rule sets out the required functions for making a good faith determination of the fair value of a fund's investments, pursuant to Section 2(a)(41) of the Investment Company Act and rule 2a-4 thereunder, each of which is designed to provide a consistent framework and standard of practice across funds:

- ***Valuation Risks.*** The Proposed Rule would require periodically assessing any material risks associated with the fund's fair value determinations, including material conflicts of interest, and managing any such valuation risks. The relevant risks, and the frequency with which the risks need to be assessed, would depend on the facts and circumstances of the particular fund's investments. The Release provides a non-exhaustive list of potential sources of valuation risks, including:
  - (i) the types of investments held or intended to be held by the fund;
  - (ii) potential market or sector shocks or dislocations;
  - (iii) the extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the adviser;
  - (iv) the proportion of the fund's investments that are fair valued as determined in good faith, and their contribution to the fund's returns;
  - (v) reliance on service providers that have more limited expertise in relevant asset classes;

(vi) the use of fair value methodologies that rely on inputs from third-party service providers, and the extent to which such third-party service providers rely on their own service providers; and

(vii) the risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.

- ***Fair Value Methodologies.*** The Proposed Rule would require the selection and consistent application of appropriate methodologies for the determination of fair value.[11] This would include specifying (i) the key inputs and assumptions specific to each asset class or portfolio holding, and (ii) the methodologies that will apply to new types of investments in which the fund intends to invest. The selected methodologies would need to be periodically reviewed for appropriateness and accuracy, and adjusted as needed.

  The Release notes that 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). With regard to periodic review and adjustment, the Release notes that the results of back-testing or calibration or a change in circumstances specific to an investment could necessitate adjustments to a fund's fair value methodologies.

  While the Release acknowledges that the appropriate methodology would depend on the facts and circumstances of each investment, the Proposed Rule would require consistency with the approaches outlined by FASB ASC Topic 820, which include the market approach, income approach and cost approach.[12] The Proposed Rule would also require the board or investment adviser to monitor for circumstances that may necessitate the use of fair value as determined in good faith, and establish criteria to be used in order to determine when market quotations are no longer reliable.[13]

- ***Testing of Fair Value Methodologies.*** The Proposed Rule would require the testing of the appropriateness and accuracy of the methodologies used to calculate fair value. Consistent with the requirements discussed above, the specific type and frequency of testing would depend on the facts and circumstances of each fund, but the fund board or investment adviser would need to identify (i) the testing methods to be used, and (ii) the minimum frequency of the testing. The Release notes the SEC's view that the results of calibration and back-testing can be particularly useful in identifying trends, and also have the potential to assist in identifying issues with methodologies applied by fund service providers, including poor performance or potential conflicts of interest.[14]

- ***Pricing Services.*** The Proposed Rule would acknowledge the prevalent use of third-party pricing services, particularly with respect to thinly traded or more complex assets, and would require a process for the approval, monitoring and evaluation of each pricing service provider that a fund may use. The list of factors that should be taken into account would include:

  (i) the qualifications, experience and history of the pricing service;

  (ii) 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;

  (iii) the pricing service's process for considering price "challenges," including how the pricing service incorporates information received from pricing challenges into its pricing information;

  (iv) the pricing service's potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and

  (v) the testing processes used by the pricing service.

  The Proposed Rule would also require the establishment of criteria for the circumstances under which price challenges would typically be initiated.

- ***Fair Value Policies and Procedures.*** The Proposed Rule would require written policies and procedures addressing the determination of the fair value of the fund's investments, which must be reasonably designed to achieve compliance with the requirements of the Proposed Rule. Where the fund board assigns fair value determinations to an investment adviser (as summarized in greater detail below), the fund's policies and procedures must be implemented by the investment adviser, subject to board oversight under rule 38a-1. Rule 38a-1 requires a fund's board to approve the fund's compliance policies and procedures, and those of each investment adviser and other specified service provider, based on a finding that the policies and procedures are reasonably designed to prevent violation of the federal securities laws.[15]
- ***Recordkeeping.*** The Proposed Rule would require the maintenance of appropriate documentation to support fair value determinations, including information regarding the specific methodologies applied and the assumptions and inputs considered when making fair value determinations, as well as any necessary or appropriate adjustments in methodologies, for at least five years from the time the determination was made (the first two in years in an easily accessible place), and a copy of the required policies and procedures discussed above.

Performance of Fair Value Determinations

Recognizing that the resources and expertise required today for determinations of fair value often make it impractical for fund directors to perform necessary valuation tasks without assistance, the Proposed Rule permits fund boards to assign fair value determinations relating to any or all fund investments to an investment adviser of the fund, who would be required to carry out the functions related to good faith determinations of fair value (as summarized above), subject to the additional requirements discussed below.[16] In developing the Proposed Rule, the SEC considered requiring boards to ratify the investment adviser's fair value determinations periodically, but determined that such an approach would not allow funds the flexibility to use most effectively the investment adviser's fair value expertise and would generally not be in line with a fund board's own experience and expertise.[17]

- ***Board Oversight.*** The Proposed Rule would impose a general duty of oversight on the part of fund boards, requiring boards to take a "skeptical and objective" view of the investment adviser's determinations. The duty of oversight would include a consideration of a 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 the determinations. The Release emphasizes that effective oversight cannot be a passive activity, and that fund directors should ask questions, seek relevant information and seek to identify opportunities to improve the investment adviser's process. Fund boards would also be expected to request follow-up information when appropriate and take reasonable steps to see that matters identified are addressed.

  The Release notes that fund boards should use the appropriate level of scrutiny based on each fund's valuation risk, including the extent to which the fair value of the fund's investments depends on subjective inputs. For example, the Release notes that 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, the SEC would expect that the board's level of scrutiny would increase correspondingly.

  The Release emphasizes that fund boards should probe the appropriateness of the adviser's fair value processes, including the financial resources, technology, staff and expertise of the adviser, the adviser's reliance on other fund service providers, and the adviser's compliance capabilities, including the oversight and financial resources made available to the adviser's chief compliance officer relating to fair value. The Release also notes that, although a board can reasonably rely on

the information provided to it by the adviser and other service providers in conducting its oversight, "it is incumbent on the board to request and review such information as may be necessary to be fully informed of the adviser's process for determining the fair value of fund investments."[18]

In addition, consistent with their obligations under the Investment Company Act and as fiduciaries, boards would be expected to seek to identify potential conflicts of interest, monitor such conflicts and take reasonable steps to manage such conflicts. In overseeing the adviser's process for making fair value determinations, the board should understand the role of, and inquire about conflicts of interest regarding, any other service providers used by the adviser as part of the process, and satisfy itself that any conflicts are being appropriately managed.

- ***Board Reporting.*** To ensure that fund boards receive tailored and relevant information that will be helpful to their oversight function, the Proposed Rule would require investment advisers to provide, at least quarterly, written assessments of the adequacy and effectiveness of the investment adviser's process. The quarterly reports would be required to provide, at a minimum, an assessment of (i) material valuation risks, (ii) material changes or deviations from methodologies, (iii) the results of any testing of fair value methodologies, (iv) the adequacy of resources allocated to the valuation process, (v) material changes to the investment adviser's process for overseeing pricing services, and (vi) any other relevant material requested by a fund's board. In this regard, the Release provides an extensive, non-exhaustive list of specific items that a board may consider reviewing in conducting its oversight, but does not mandate review of individual portfolio holdings.[19] However, the Release requests comment on whether there are circumstance that would warrant review of individual portfolio holdings or other specific information.

  The investment adviser would also be expected to provide prompt written reports to the fund board regarding matters that materially affect, or could have materially affected,[20] the fair value of the investments (*e.g.*, significant deficiencies or material weaknesses in the investment adviser's valuation process). The Proposed Rule would require such written reports to be provided no later than three business days after the investment adviser becomes aware of the matter. The Release notes that some situations may warrant an immediate report.

- ***Specification of Functions.*** The Proposed Rule would require the investment adviser to specify the titles and particular functions of the people responsible for determining the fair value of the assigned investments. To the extent the investment adviser uses a valuation committee or similar body to assist in the valuation, the policies and procedures would be expected to describe the composition and role of such committee. The investment adviser would also be expected to reasonably segregate the process of making fair value determinations from the portfolio management of the fund, in part to avoid potential conflicts of interest.

- ***Records of Assignment.*** The Proposed Rule would require the funds to keep certain records related to an investment adviser's fair value determinations, including copies of reports provided to the fund board and a specified list of investments or investment types that have been assigned. These records would also be subject to a five-year retention period.

Readily Available Market Quotations

The Release acknowledges that neither the Investment Company Act nor the rules thereunder define when market quotations are "readily available" for the purpose of determining whether a fund's investments should be valued based on market value or on fair value. The Proposed Rule would provide that a market quotation is readily available for purposes of Section 2(a)(41) of the Investment Company Act only when (i) that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, and (ii) the quotation is reliable.[21] The Release reaffirms the SEC's position that evaluated prices are not, by themselves, readily available market quotations, and notes that

indications of interest and accommodation quotes would not be treated as readily available market quotations under the Proposed Rule.

Rescission of Prior SEC Releases and Staff Guidance; Proposed Transition Period

The Proposed Rule would rescind ASR 113 and ASR 118 in their entirety. Although the releases had provided specific guidance with respect to the recognition, measurement and disclosure of investment securities, the Release notes that developments in accounting standards, such as the FASB standards and U.S. GAAP, have modernized and superseded the approach to the accounting topics that were addressed in ASR 113 and ASR 118. The Release also presents a preliminary list of staff letters and guidance that would be withdrawn by the Proposed Rule and invites commenters to identify any additional letters or guidance that may need to be withdrawn.

The Proposed Rule, if adopted, would be effective one year after the publication of the final rule in the Federal Register, upon which ASR 113, ASR 118 and any additional identified guidance would be withdrawn.

CONSIDERATIONS FOR FUND BOARDS

The Proposed Rule represents a significant development with respect to a fund's valuation practices and should generally be well received by fund boards. As noted above, many of the requirements are generally consistent with policies or practices that have been adopted by many fund boards. Indeed, many fund boards will already be accustomed to a role of active oversight regarding the valuation process of the fund's investment adviser, including reviewing the types of information contemplated by the Proposed Rule and evaluating the resources and expertise of the investment adviser, including the composition of its valuation committee, along with associated conflicts of interest. However, although the Proposed Rule would provide a substantial degree of compliance certainty for fund boards with respect to fair value determinations, both the Proposed Rule and the guidance in the Release would require fund boards to adhere to a highly prescriptive set of requirements, including specific requirements and expectations in how the board carries out its oversight function. In connection with assessing the Proposed Rule and the guidance provided in the Release, fund boards should carefully consider their current practices and determine what, if any, changes could be necessitated.

In considering whether any aspects of the Proposed Rule may be overly prescriptive, commenters should also consider whether a more principles-based approach to the rule, which was contemplated by the SEC as a reasonable alternative,[22] would be preferable to accommodate the wide variation in funds' operations, investment strategies and practices. As an alternative to the prescriptive structure of the Proposed Rule, commenters could considering requesting that the SEC instead provide Commission-level guidance for determining fair value in "good faith," which would provide boards with the benefits of compliance certainty yet preserve flexibility for each board to determine the approach it deems appropriate to oversee the

investment adviser's fair value processes. A similar approach was recently taken by the SEC in its guidance relating to the proxy voting responsibilities of investment advisers.[23] Alternatively, a final rule structured as a safe harbor would provide similar benefits—providing certainty that boards will be deemed to have made the fair value determination in "good faith" by following the prescriptive requirements of the rule, but not mandating that boards do so where circumstances do not warrant.[24]

Finally, with respect to the transition period contemplated by the Proposed Rule, commenters may want to request that the SEC provide accommodation for early compliance, as it has done in other recent rulemakings,[25] to allow fund boards to benefit sooner from the potential for increased compliance certainty provided by the Proposed Rule.

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ENDNOTES

1 Good Faith Determinations of Fair Value, SEC Release No. IC-33845 (Apr. 21, 2020) (the "Release").

2 *See*, *e.g.*, Dalia Blass, Director of the Division of Investment Management, Keynote Address: ICI Securities Law Developments Conference (Dec. 7, 2017), *available at*: https://www.sec.gov/news/speech/blass-keynote-ici-securities-law-developments-conference-2017; Dalia Blass, Director of the Division of Investment Management, Remarks at the IDC – 2018 Fund Directors Conference (Oct. 16, 2018), *available at*: https://www.sec.gov/news/speech/speech-blass-101618. Through this initiative, SEC staff has sought to modernize its regulatory approach to investment companies and sought to engage in an informative dialogue with fund boards and directors in order to seek to recalibrate the role of a fund's board focusing on where they can be most valuable.

3 Commissioner Hester M. Peirce, Statement on Good Faith Determinations of Fair Value under the Investment Company Act of 1940 Proposal (April 21, 2020), *available at*: https://www.sec.gov/news/public-statement/statement-peirce-fair-value-2020-04-21.

4 *See*, *e.g.*, Section 22(c) of the Investment Company Act and rule 22c-1(a) thereunder. Section 23(c) of the Investment Company Act provides for repurchases of closed-end fund shares. The shares of closed-end funds that are listed on an exchange often trade at a premium or discount to NAV.

5 Section 2(a)(41) of the Investment Company Act and rule 2a-4 thereunder.

6 *Id.* As used in this memorandum, references to fair value as determined in good faith by the board of directors relate to fair value of securities where market quotations are not readily available.

7 Investment Company Act Release No. 13890 (Apr. 16, 1984).

8 Investment Company Act Release No. 6295 (ASR 118) (Dec. 23, 1970).

9 *See* Sarbanes-Oxley Act of 2002; SEC rules 38a-1 and 206(4)-7 (compliance rules under the Investment Company Act and Investment Advisers Act of 1940); Financial Accounting Standards Board ASC Topic 820 ("FASB ASC Topic 820") (defining "fair value" for purposes of accounting standards and establishing a framework for the recognition, measurement, and disclosure of fair value under U.S. generally accepted accounting principles ("U.S. GAAP")).

10 Many BDCs retain an independent evaluator to aid the board in its determination of the fair value of the BDC's illiquid investments, which for many BDCs is all or substantially all of the BDC's portfolio. The Release does not specifically discuss this practice, but the board of such a BDC would be able to assign the determination of fair value to the BDC's investment adviser consistent with the Proposed Rule and the BDC's valuation policies and procedures.

In the case of a unit investment trust ("UIT"), because a UIT does not have a board of directors or investment adviser, a UIT's trustee would conduct fair value determinations under the proposed rule.

11 The Release acknowledges that there may be circumstances in which it is appropriate to adjust the methodology used if such adjustments would result in a measurement that is equally or more representative of the fair value of the investment. Therefore, the requirement to apply methodologies in a consistent manner would not preclude the board from changing the methodology where the circumstances of the particular investment call for an adjustment. *See* Release at 21.

12 *See* FASB Accounting Standard Codification Topic 820.

13 As an example, the Release notes that if a fund invests in securities that trade in foreign markets, a fund's board or adviser 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. *See* Release at 22.

14 As an example, the Release notes that if a specific methodology consistently over-values or under-values one or more fund investments as compared to observed transactions, the board or adviser should investigate the reasons for this difference. *See* Release at 24.

15 *See* rule 38a-1 under the Investment Company Act. Rule 38a-1 also includes a number of additional requirements, such as the appointment by each fund's board of a chief compliance officer with responsibility for implementing the fund's compliance program, and for making an annual report to the fund board. The Release notes that rule 38a-1 would "encompass a fund's compliance obligations with respect to proposed rule 2a-5, if adopted, and would require a fund's board to oversee compliance with the rule." To the extent that adviser policies and procedures under proposed rule 2a-5 would otherwise be duplicative of fund valuation policies under rule 38a-1, a fund could adopt the rule 2a-5 policies and procedures of the adviser in fulfilling its rule 38a-1 obligations. *See* Release at 27.

16 Notwithstanding the focus on the role of the investment adviser, a fund board may still choose to make its own good-faith determinations of fair value. In such a case, the fund board would not be subject to the requirements associated with an assignment of fair value determinations to the investment adviser.

17 *See* Release at 105-106. Board ratification of the fair value determinations by the fund's investment adviser has never been expressly required by the SEC, and we do not believe there is a universally accepted industry practice. However, in a 2012 webinar hosted by the Mutual Fund Directors Forum, Douglas Scheidt, the then-Chief Counsel of the Division of Investment Management, spoke at length on his views regarding board oversight of valuation, including that the Investment Company Act requires the board to "embrace"—by explicit approval, ratification or affirmation—a fair valuation determined by a delegate of the board outside the board pre-approved procedures. Douglas J. Scheidt, Associate Director & Chief Counsel of the Division of Investment Management, Remarks at Mutual Fund Directors Forum Webinar, Board Oversight of Valuation: The SEC's Perspective (Sept. 20, 2012) (transcript not publicly available). By considering, and expressly not adopting, a requirement for the fund board to ratify the investment adviser's fair value determinations, the Release should helpfully clarify the confusion in the industry regarding this point.

18 *See* Release at 37.

19 These items include: (i) summaries of adviser price challenges to pricing information provided by third-party vendors and of price overrides, including back-testing results related to the use of price challenges and overrides; (ii) specific calibration and back-testing of data, including whether fair value prices moved in the same direction (relative to the prior market prices) as the portfolio holdings' next actual market prices, whether fair value prices were closer to the portfolio holdings' next actual market prices than the prior market prices (regardless of the direction), and whether the difference between the fair value prices and the subsequent prices was greater than pre-established tolerance levels; (iii) reports regarding portfolio holdings for which there has been no change in price or for which investments have been held at cost for an extended period of time ("stale prices"); (iv) reports regarding portfolio holdings whose price has changed outside of predetermined ranges over a set period of time; (v) narrative summaries or reports on pricing errors, including the date of any error, the cause, the impact on the fund's NAV, and any remedial actions taken in response to the error; (vi) reports on the adviser's due diligence of pricing services used by the fund; (vii) the results of testing by the fund's independent auditor provided to the audit committee; (viii) reports analyzing trends in the number of the fund's portfolio holdings that received a fair value, as well as the percent of the fund's assets that received a fair value; and (ix) reports on the number and materiality of securities whose fair values were determined based on information provided by broker-dealers; the broker-dealers most frequently used for this purpose; and the results of back-testing on the information they provided. *See* Release at 45-47.

ENDNOTES (CONTINUED)

[20] The Release states that the phrase "could have materially affected" is intended to capture circumstances where, for example, a matter was detected which affected one security and which may not be material on its own, but, had the matter not been identified, could have materially affected the larger assigned portfolio of investments or some subset of that portfolio. According to the Release, this concept is not intended to mandate reporting in circumstances where, at the time the matter was detected, it did not seem that the matter would materially affect the fair value of the assigned portfolio but the matter later ended up having such an effect. *See* Release at 49.

[21] A market quotation would be considered unreliable under the Proposed Rule if it would require an adjustment or consideration of additional inputs in order to determine the value of the security pursuant to U.S. GAAP. *See* Release at 58.

[22] *See* Release at 103-104.

[23] *See* Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers (Aug. 21, 2019), *available at*: https://www.sec.gov/rules/interp/2019/ia-5325.pdf (providing "examples to help facilitate investment advisers' compliance with their proxy voting responsibilities [which are] not the only way by which investment advisers could comply with their principles-based fiduciary duty imposed on them by the Advisers Act").

[24] Structuring a rule as a safe harbor is an approach commonly taken by the SEC. *See, e.g.,* rules 3a-2, 3a-4 and 15a-2 under the Investment Company Act; rules 144, 147, 163A and 506(b) under the Securities Act of 1933; and rule 10b-18 under the Securities Exchange Act of 1934. We note that this safe harbor alternative would generally not implicate the costs discussed in the Economic Analysis of the Release relating to compliance uncertainty, where the alternative considered by the SEC was simply a rule that stated that funds should have in place policies and procedures, reporting and recordkeeping that would allow fair values to be determined in good faith by the board of directors or the investment adviser. *See* Release at 103-104.

[25] *See e.g.*, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, SEC Release No. BHCA-7 (Sept. 18, 2019) (allowing banking entities to comply voluntarily, in whole or in part, with the amended rules in advance of the compliance deadline); Form CRS Relationship Summary; Amendments to Form ADV, SEC Release Nos. 34-86032; IA-5247 (June 5, 2019) (allowing investment advisers to file the relationship summary in advance of the compliance deadline); Modernization of Property Disclosures for Mining Registrants, SEC Release Nos. 33-10570; 34-84509 (Oct. 31, 2018) (allowing registrants to comply voluntarily with the new rules prior to the compliance deadline).

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