MEMO# 27544

September 5, 2013

ICI Submits Letter to SEC Staff on Fund Valuation

[27544]

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TO: SEC RULES COMMITTEE No. 34-13
ACCOUNTING/TREASURERS COMMITTEE No. 26-13
END OF DAY PRICING FORUM No. 11-13
SMALL FUNDS COMMITTEE No. 18-13 RE: ICI SUBMITS LETTER TO SEC STAFF ON FUND VALUATION

As you know, ICI staff met with SEC staff earlier this year to discuss the potential issuance of valuation guidance, consideration of which is one of the top priorities for the SEC's Division of Investment Management and its Director, Norm Champ. [1] We have submitted the attached letter as a follow-up to that meeting.

Please note that, unlike most other ICI letters to the SEC Staff, this letter is not a response to any particular rulemaking or SEC release and, accordingly, is not publicly available. Therefore, you should treat it as you would any committee business. Feel free to share it within your firm, but do not circulate it more widely.

The letter's primary point is that we do not believe that Commission guidance on valuation is either necessary or desirable at this time. The letter outlines a number of reasons why, including that the existing Commission and Staff guidance remains sound and valuation policies and procedures are more robust now than ever, as they are constantly being revisited, adjusted, and strengthened. The letter questions whether a mere compilation "rolling up" prior guidance is necessary and the best use of scarce Staff resources, noting in particular the existence of the Staff's own bibliography on valuation and ICI's valuation compendium. It also highlights the risk that even minor wording changes to existing guidance may prove confusing or unhelpful, as well as the risk that new guidance could introduce conflicts with fair value measurement guidance under generally accepted accounting principles (GAAP).

Recognizing that the Staff's consideration of potential valuation guidance is a high priority, however, the letter makes two other general points: that any valuation guidance, if issued, should be both prospective and principles-based, and that, in light of a recent settled enforcement action, any guidance should confirm that the appropriate role for a fund board is one of oversight and not the day-to-day administration of the fund's valuation policies and procedures (the latter being a function appropriate for fund management).

The letter then addresses several topics that were discussed during our meeting. These topics include:

- The pricing of fixed income securities and the use of pricing vendors. A significant portion of our meeting focused on the relationship between funds and pricing services, particularly with respect to the pricing of fixed income securities. The letter briefly describes the types of due diligence commonly conducted on pricing services, while noting that the nature of this due diligence process will vary depending on the extent of the anticipated relationship (e.g., the size of the complex, the number of funds involved, the number and nature of securities involved, and the expectations for the relationship being a primary or secondary source of pricing information). To the extent that the Staff intends to recommend additional guidance on funds' use of pricing services, the letter strongly recommends that it keep two key points in mind. First, the due diligence process appropriately is conducted by fund management, not the board. [2] Second, the Commission's guidance should not set expectations for a level of due diligence that effectively makes it cost prohibitive for many fund complexes to invest in certain types of instruments or utilize a pricing service.
- The potential for distinctions among types of fair valuations. The letter states that, if the Staff decides to articulate a principle incorporating distinctions along the lines of the FAS 157, [3] it is imperative that the guidance be consistent with the Financial Accounting Standards Board (FASB) and complementary to the considerable work done to assign each valuation to its appropriate level.
- The role of investment personnel and fund directors in valuation committees. If the Staff intends to address the use of valuation committees in its guidance, the letter recommends that it keep two things in mind. First, any Commission guidance should recognize the significant input investment professionals can provide and not exclude them from the pricing process, but also should recognize the need to address actual and potential conflicts of interest. The letter argues that funds should have the flexibility to design policies and procedures to best address the particular conflicts their investment personnel face, consistent with the size of the firm and the resources available to it, the nature of the fund's portfolio securities, and the extent of investment personnel involvement in the valuation process. Second, Commission guidance should remain flexible with respect to the role of fund directors on valuation committees. The letter notes that the use and composition of valuation committees vary widely in the industry. To the extent Commission guidance addresses the use of valuation committees, it should distinguish carefully between board-level and management-level valuation committees and, more importantly, should not suggest that directors should participate on management-level valuation committees. Rather, any principle related to valuation committees should recognize that direct participation on a management-level valuation committee is not necessary for directors to fulfill their good faith responsibilities to oversee the valuation process.
- Auditing guidance. From our meeting, we understand the Staff is considering updating existing auditing guidance to permit a controls-based approach to auditing security values in lieu of independently verifying all quotations used by the fund at the balance sheet date. The letter states that we see no practical benefit associated with the removal of the requirement. Given the magnitude of a fund's investment securities in relation to its overall financial position, we believe auditors likely would continue to verify independently 100 percent of the quotations used by the fund at the balance sheet date, and independent directors overseeing the audit of the fund's

financial statements likely would request that it be performed as part of the audit, even if not formally required. The letter states that it may be appropriate, however, to update other auditing guidance relating to the form of the auditor's opinion.

Robert C. Grohowski
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Attachment

endnotes

[1] See Memorandum No. 27264, dated June 4, 2013.

[2] In this regard, the letter notes that it would be unusual, and should not be required or expected, for the board or any individual directors to be directly involved in the due diligence process. Rather, the board's role should be to ensure that management's due diligence is reasonable.

[3] FAS 157 established a framework for measuring fair value in accordance with GAAP and expanded disclosures about fair value measurements that includes a three-level fair value hierarchy that distinguishes between (1) assumptions based on market data obtained from independent sources (observable inputs) and (2) assumptions based upon the best other information available in the circumstances (unobservable inputs).
