

**MEMO# 29831**

April 12, 2016

# **Evaluating Fund Policies, Procedures, and Disclosure in Light of Unanticipated Events on Securities Trading Venues**

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TO:

Accounting/Treasurers Members No. 6-16  
Bank, Trust and Retirement Advisory Committee No. 11-16  
Broker/Dealer Advisory Committee No. 11-16  
Compliance Members No. 8-16  
End of Day Pricing Forum No. 6-16  
Equity Markets Advisory Committee No. 13-16  
Investment Company Directors No. 10-16  
Operations Members No. 9-16  
SEC Rules Members No. 15-16  
Small Funds Members No. 13-16  
Transfer Agent Advisory Committee No. 15-16

RE:

Evaluating Fund Policies, Procedures, and Disclosure in Light of Unanticipated Events on Securities Trading Venues

Unanticipated events involving securities exchanges or other trading venues have the potential to disrupt critical operational functions, such as fund pricing. On July 8, 2015, the New York Stock Exchange (“NYSE”) suspended trading midday but resumed trading before the 4:00 p.m. market close. [\[1\]](#) The exchange closed that day without further incident. Because the NYSE was able to resume trading and close in an orderly fashion, funds ultimately were able to price their shares as usual in accordance with their policies and procedures.

Recognizing the likelihood of future outages, many fund complexes have been evaluating the adequacy of their (i) policies and procedures for valuing portfolio assets and pricing, issuing, and redeeming fund shares and (ii) related disclosure. This memorandum is meant

to assist member firms as they perform these reviews. [2]

## Background

Unanticipated disruptions in the functions of exchanges and other trading venues raise legal and operational considerations for open-end funds (“funds”), relating to issues such as trade execution, valuation of portfolio assets, pricing of fund shares, and processing transactions in fund shares. [3] Funds often look primarily to a security’s daily closing price on the security’s primary listing market or exchange (quite commonly, the NYSE) for purposes of valuing that security. Thus, primary listing markets’ timely dissemination of closing prices is critical to funds’ daily valuation processes.

Unanticipated disruptions affecting the NYSE, in particular, can have unique legal and operational ramifications for funds. Some funds, pursuant to their Rule 22c-1 policies, [4] price their fund shares only on days the NYSE is open, and do so as of the close of trading on the NYSE (generally 4:00 p.m. Eastern Time). As the July 2015 trading halt made clear, an exchange could suspend trading for a period of time or unexpectedly close early under certain circumstances, even though trading continues on other exchanges. This is an occurrence that funds may wish to address in their policies and procedures and reflect in their disclosure to shareholders.

The status of the NYSE also may affect whether a fund may suspend redemptions of fund shares: NYSE closings (other than customary closings) and certain NYSE trading restrictions (as the SEC determines) are two exceptions to the general rule that funds may not suspend redemptions. Funds may decide to remain open and continue to process transactions, despite otherwise being permitted to suspend redemptions. [5] Even so, it is important for funds to address those circumstances in their policies and procedures and reflect them in their disclosure to shareholders.

In addition to having in place policies and procedures for valuing portfolio assets and pricing, issuing, and redeeming fund shares, a fund must provide certain related disclosure to investors in its prospectus and statement of additional information (“SAI”). [6] A fund’s disclosure must satisfy the requirements of Form N-1A and remain consistent with the fund’s relevant policies and procedures, particularly as they change.

Below are matters that members may wish to consider as they evaluate their policies, procedures, and related disclosure.

## Matters to Consider

- *Valuation policies and procedures:* As noted above, funds often look primarily to a security’s closing price on its primary listing market or exchange (e.g., the NYSE) for purposes of valuing that security. In the event of an unexpected close of the primary listing market, a security may continue to trade on one or more other markets, [7] and the price as reflected on those other trading venues may be more reflective of the security’s value than an earlier price from the primary listing market. [8] Accordingly, funds may wish to review their current valuation policies to determine whether they provide for use of these additional sources of pricing data or information when prices from the primary listing market are unavailable, or are earlier and less representative of current market value. [9]
- *Consideration of a fund’s time for pricing fund shares and accepting orders:* Rule 22c-1 provides funds with flexibility regarding when and how often they must price

their shares.<sup>[10]</sup> Consequently, fund policies vary with respect to the time when they price fund shares and stop accepting purchase and redemption orders (the “cut-off time”). Some funds simply stipulate a fixed cut-off time (e.g., 4:00 p.m. Eastern Time); others stipulate that their cut-off time will coincide with the close of trading on the NYSE.<sup>[11]</sup> Most of the time, these policies will yield the same result, because the NYSE ordinarily closes at 4:00 p.m. Eastern Time.<sup>[12]</sup>

But this need not be the case. Had the NYSE not resumed trading on July 8 and “closed” as of 11:32 a.m., the two types of policies would have produced different results. A fund stipulating a fixed cut-off time would have valued all portfolio assets and priced its shares as of that time (e.g., 4:00 p.m.). Orders received up to the fixed cut-off time would have received the cut-off time price. By contrast, a fund tying its cut-off time to the NYSE’s closing time would have valued all portfolio assets and priced its shares as of 11:32 a.m. Orders received prior to 11:32 a.m. would have received that day’s fund share price as of 11:32 a.m., and orders received after 11:32 a.m. would have received the next day’s price as of the cut-off time. This unexpected early close could have resulted in challenges for funds, relating to both valuation and processing of orders. And even this scenario assumes the ability to make a fairly quick and definitive judgment about the NYSE’s status, which may not always be possible. When an intraday disruption continues for an indeterminate period of time and the NYSE is unable to specify if or when it will resume operations, a fund may not know until late in the day (close to the customary NYSE closing time) the proper cut-off time for that day.

Funds should choose a suitable approach after considering valuation and operational issues. This could include consideration of the capabilities of service providers such as pricing vendors (e.g., whether they can provide reliable values for securities at unanticipated times of the day) and intermediaries (e.g., whether they can apply an unanticipated fund cut-off time and sort purchase and redemption orders accordingly). Relative advantages to a fixed time are clarity (e.g., a fund need not determine what constitutes “closure” of the NYSE or any other market for this purpose) and operational ease (e.g., intermediaries have a simple policy for the daily segregation of purchase and redemption orders, and such a policy is in accord with typical industry practices). A relative advantage to tying a fund’s cut-off time to that of the securities exchanges generally (or the NYSE specifically) is that if an event disrupted activity across a number of markets and normal trading activity did not resume prior to 4:00 p.m., a fund could use the early closing prices for purposes of valuing fund assets and pricing fund shares, thereby avoiding the practical difficulties associated with developing fair values for a large number of securities in a compressed time frame.<sup>[13]</sup>

- Enhancing fund policies and related disclosure: Whichever general option a fund adopts, there nevertheless may be ways of elaborating on Rule 22c-1 policies and related disclosure to describe steps or approaches funds plan to take in response to unanticipated market events. In doing so, the objectives should be to improve funds’ ability to accommodate these events while still providing shareholders a clear sense of likely outcomes from the application of these policies. For example, funds that prefer tying their cut-off time to the close of one or more securities exchanges may wish to consider the following possible types of enhancements to their current policies and disclosure:
  - In light of the July 2015 NYSE trading halt, a fund might tie its cut-off time (and

the days that the fund itself will be open) to a broader measure of market activity than the NYSE and/or one better aligned with the fund's portfolio assets (see Appendix, Example #1).

- When a market such as the NYSE experiences trading disruptions, a fund may be left with interpretive questions about the market's status for purposes of applying its Rule 22c-1 policies. Therefore, a fund may wish to provide disclosure about its general approach to these events (see Appendix, Example #2).
  - A fund preferring to tie its daily cut-off time to that of the NYSE might specify that the relevant time would be the time as of which the NYSE determines official closing prices (see Appendix, Example #3)—in the event that the NYSE were to close early unexpectedly but determine prices for its securities as of a later time, this later time would control for purposes of the fund's cut-off time.[\[14\]](#)
- *Board involvement:* Fund boards play an important role in the valuation process, which includes approving fund valuation policies and procedures.[\[15\]](#) Rule 22c-1(d) states that the fund board also “shall initially set the time or times during the day that the current net asset value shall be computed, and shall make and approve such changes as the board deems necessary.” Therefore, the fund board should review and approve any material changes to a fund's valuation policies and procedures and policies regarding when the fund will price its shares. Funds also should be mindful of any other applicable procedural requirements (e.g., the need for approvals by entities such as the adviser's valuation committee) prior to making any changes.
  - *Communication with intermediaries:* Effective communication with fund intermediaries is important in at least two broad respects. First, if a fund wishes to make changes to its Rule 22c-1 policies, it should first seek to ensure that the intermediaries can properly apply the new policies and then communicate any final changes in advance of implementation to its intermediaries. Second, in cases where a fund's cut-off time, consistent with its Rule 22c-1 policies, will deviate from the norm on a given day, it is imperative that the fund communicate that to its intermediaries as promptly as possible, so that they are in the best position possible to apply the proper cut-off time for purposes of sorting purchase and redemption orders.[\[16\]](#)

In either situation, to ensure widespread dissemination of this information, funds should use multiple channels of communication, such as websites, blast faxes, mass e-mail distributions, and industry utilities.

- *Changes to fund disclosure:* A fund must provide shareholders with disclosure about its procedures for valuing portfolio assets and pricing, issuing, and redeeming fund shares in its prospectus and SAI.[\[17\]](#) Therefore, any changes to these policies and procedures could require conforming changes to the fund's prospectus and SAI disclosure. If multiple funds in a fund complex are considering similar changes to their policies and procedures, the fund complex may wish to have the changes take effect across all applicable funds at the same time, and make all disclosure changes at the same time. This may help ensure consistency and proper implementation (particularly by intermediaries) of the changes across the fund complex.

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### Appendix

Following are examples of potential enhancements to policies and disclosure that a fund might consider in anticipation of unexpected events affecting securities exchanges or other trading venues.

Example #1: Share price, also known as net asset value (NAV), is normally calculated each business day as of the later of the close of regular trading on the New York Stock Exchange (NYSE) or the Nasdaq, generally 4 p.m., Eastern time.

Example #2: The net asset value of the Fund is determined each day the NYSE is open for trading as of the close of regular trading on the NYSE (generally 4:00 p.m. Eastern time). The fund will not treat an intraday unscheduled disruption in NYSE trading as a closure of the NYSE and will price its shares as of 4:00 p.m., if the particular disruption directly affects only the NYSE.

Example #3: The price of each class of the fund's shares is based on its net asset value. The net asset value of each class of shares is determined each day the NYSE is open for trading at the time as of which the NYSE establishes official closing prices (generally 4:00 p.m. Eastern time).

### endnotes

[1] Trading on NYSE MKT also was suspended. Trading on NYSE ARCA, Arca Options and NYSE AMEX Options, and on other unrelated markets, was unaffected. According to the NYSE, “[T]here were communication issues between customer gateways and the trading unit with the new release [of Tuesday night’s rollout of software]. It was determined that the NYSE and NYSE MKT customer gateways were not loaded with the proper configuration compatible with the new release.” See Institute [Memorandum No. 29164](#), dated July 10, 2015, for a description of the event, ICI’s response, general suggestions to members, and ICI resources available to members.

[2] Since the July 2015 NYSE trading halt, we have had a number of calls focused on these matters with ICI members and the staff of the SEC’s Division of Investment Management. While the SEC staff reviewed this memorandum, as a matter of policy, their review does not indicate agreement with, or approval of, its contents. Nothing contained in this memorandum is intended to serve as legal advice. Each fund, fund board, and investment adviser should seek the advice of counsel for issues related to its individual circumstances.

[3] See, e.g., Section 2(a)(41) of the Investment Company Act of 1940 (“Investment Company Act”) and Rules 2a-4 and 22c-1 thereunder.

[4] Generally speaking, Rule 22c-1 under the Investment Company Act requires funds, their principal underwriters, and dealers in fund shares to sell and redeem fund shares at a

price determined at least daily based on the current net asset value next computed after receipt of an order to buy or redeem.

[5] Section 22(e) of the Investment Company Act states, “No registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption, except—

1. or any period (A) during which the New York Stock Exchange is closed other than customary week-end and holiday closings or (B) during which trading on the New York Stock Exchange is restricted;
2. for any period during which an emergency exists as a result of which (A) disposal by the company of securities owned by it is not reasonably practicable or (B) it is not reasonably practicable for such company fairly to determine the value of its net assets; or
3. for such other periods as the Commission may by order permit for the protection of security holders of the company.

The Commission shall by rules and regulations determine the conditions under which (i) trading shall be deemed to be restricted and (ii) an emergency shall be deemed to exist within the meaning of this subsection.”

[6] Specifically, Item 11(a) of Form N-1A requires a fund to describe in its prospectus the procedures for pricing its shares, including a brief explanation of the circumstances under which it will use fair value pricing; a statement as to when calculations of net asset value are made and that the price at which a purchase or redemption is effected is based on the next calculation of net asset value after the order is placed; and a statement identifying in a general manner any holidays when fund shares will not be priced. Item 23(c) of Form N-1A requires a fund to describe in its SAI the method followed in determining the total offering price at which the fund’s shares may be publicly offered, and the method(s) used to value the fund’s assets (including a description of valuation procedures).

[7] As a result of changes in market structure (including the growth of alternative markets), the NYSE’s market share of transactions in NYSE-listed securities has been falling over time. *See, e.g., Memorandum on Rule 611 of Regulation NMS* from the SEC Division of Trading and Markets to the SEC Market Structure Advisory Committee, at 10-11, 21 (Apr. 30, 2015), available at: [www.sec.gov/spotlight/emsac/memo-rule-611-regulation-nms.pdf](http://www.sec.gov/spotlight/emsac/memo-rule-611-regulation-nms.pdf) (“[M]arket share and visible fragmentation metrics for NYSE stocks changed dramatically from 2005 to 2014. NYSE, the largest venue, saw its market share decline from 78.9% to 20.1%...”).

[8] According to a July 2015 press release, the NYSE and Nasdaq are attempting to create a more resilient market by providing an additional layer of redundancy for the closing auction of U.S. equities. *Available at* <https://ir.theice.com/press/press-releases/all-categories/2015/07-22-2015>. Among other things, “in the event the NYSE, NYSE Arca or NYSE MKT are unable to run a closing auction in some or all NYSE-listed securities, NYSE will use the resulting price of the Nasdaq Closing Cross in those securities as the official NYSE closing price.” In December 2015, the SEC announced immediate effectiveness of amendments to NYSE Rule 123C, which added as a new defined term “Official Closing Price.” The definition sets forth the means by which the NYSE will establish the Official Closing Price for each NYSE-listed security each day, including if the NYSE is unable to conduct a closing transaction in a security or securities



due to a systems or technical issue. See *Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to NYSE Trades Market Data Product Offering*, SEC Release No. 34-76599 (Dec. 9, 2015), available at [www.sec.gov/rules/sro/nyse/2015/34-76599.pdf](http://www.sec.gov/rules/sro/nyse/2015/34-76599.pdf). The NYSE has since proposed further amendments to the definition of “Official Closing Price” that would establish a methodological hierarchy for determining Official Closing Prices if the NYSE is unable to conduct closing transactions due to a systems or technical issue. See *Notice of Filing of Proposed Rule Change Amending Rule 123C to Provide for How the Exchange Would Determine an Official Closing Price if the Exchange is Unable to Conduct a Closing Transaction*, SEC Release No. 34- 77305 (Mar. 7, 2016), available at [www.sec.gov/rules/sro/nyse/2016/34-77305.pdf](http://www.sec.gov/rules/sro/nyse/2016/34-77305.pdf). In the event that the exchanges implement additional changes in this area, funds may wish to revisit the topics addressed in this memorandum.

[9] In the absence of readily available market quotations, a fund should determine the fair value of its securities pursuant to policies and procedures approved by the fund’s board. See Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder. See also *Compliance Programs of Investment Companies and Investment Advisers*, SEC Release No. IC-26299, 68 Fed. Reg. 74714, 74718 (Dec. 24, 2003) (expressing the SEC’s expectation that funds’ (or their service providers’) policies and procedures cover certain critical areas, including pricing of portfolio securities and fund shares).

[10] Specifically, Rule 22c-1(b)(1) states, “The current net asset value of any such security shall be computed no less frequently than once daily, Monday through Friday, at the specific time or times during the day that the board of directors of the investment company sets, in accordance with paragraph (e) of this section, except on: (i) Days on which changes in the value of the investment company’s portfolio securities will not materially affect the current net asset value of the investment company’s redeemable securities; (ii) Days during which no security is tendered for redemption and no order to purchase or sell such security is received by the investment company; or (iii) Customary national business holidays described or listed in the prospectus and local and regional business holidays listed in the prospectus...”

[11] In discussing these matters with members and the SEC staff and preparing this memorandum, we reviewed a sample of relevant disclosure appearing in members’ prospectuses and SAs. This memorandum describes considerations related to two general approaches to setting the time for pricing fund shares, but expresses no preference for or recommendation of any particular policy or approach. It is up to each fund to determine which policy or approach it finds most appropriate, and funds may take approaches other than those discussed in this memorandum.

[12] There are a few days each year when the NYSE has an early scheduled close, e.g., the Friday after Thanksgiving and Christmas Eve.

[13] Generally speaking, intermediaries are better able to apply an unanticipated cut-off time when a disruption is broad, its status becomes clear relatively quickly, and it affects funds in a similar manner. By contrast, intermediaries are less able to apply an unanticipated cut-off time when a disruption is narrow (e.g., it affects only one market), its status is uncertain for a prolonged period of time, and it affects funds in idiosyncratic ways because of funds’ differing policies.

[14] See *supra*, note 8

[\[15\]](#) See, e.g., Section 2(a)(41) of the Investment Company Act and Rules 2a-4 and 38a-1 thereunder.

[\[16\]](#) See *supra*, note 13.

[\[17\]](#) See *supra*, note 6.

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