

MEMO# 11466

December 14, 1999

SEC STAFF GUIDANCE REGARDING MUTUAL FUND PRICING OBLIGATIONS UNDER THE FEDERAL SECURITIES LAWS

1 Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated December 8, 1999. [11466] December 14, 1999 TO: DIRECTOR SERVICES COMMITTEE No. 26-99 RE: SEC STAFF GUIDANCE REGARDING MUTUAL FUND PRICING OBLIGATIONS UNDER THE FEDERAL SECURITIES LAWS

The staff of the SEC's Division of Investment Management recently issued a letter to the Institute providing guidance regarding mutual funds' obligations to price and redeem their securities under the federal securities laws.¹ The staff's letter clarifies that market quotations for portfolio securities are not readily available when the exchanges or markets on which those securities trade do not open for trading for the entire day, and that funds, accordingly, must price those securities based on their fair value. The letter also provides guidance regarding the fair value pricing process, including the factors that funds should consider when fair value pricing portfolio securities. Finally, the letter discusses the obligations of fund boards of directors for fair value pricing securities, including the measures they may take when discharging those responsibilities. The letter is attached, and it is summarized below.

Section 22(e) and Rule 22c-1 The staff's letter reviews funds' pricing and redemption obligations under Section 22(e) of the Investment Company Act of 1940 and Rule 22c-1 thereunder, and notes that for purposes of Section 22(e), the staff considers the New York Stock Exchange to be closed on any day when it does not open for trading for the entire day. The letter adds that when funds encounter difficulties in selling or pricing their portfolio securities due to market breaks, trading restrictions, internal fund failures, or natural disasters, among other things, Section 22(e) does not permit funds to suspend redemptions in the absence of certain determinations by the Commission. Availability of Market Quotations The letter states that the 1940 Act requires funds to value their portfolio securities by using the market value of the securities when market quotations for the securities are readily available; when market quotations are not readily available, the 1940 Act requires a fund's

2 Following that earthquake, the Taiwan Stock Exchange was closed for a number of days. Accordingly, in the staff's view, market prices for securities traded on the TSE were not "readily available" and thus funds holding those securities were required to use fair value pricing in determining their net asset value.

3 The letter lists the following factors that fund boards may need to consider, if relevant: (1) the value of other financial instruments, including derivative securities, traded on other markets or among dealers; (2) trading volumes on markets, exchanges, or among dealers; (3) values of baskets of securities traded on other markets, exchanges or among dealers; (4) changes in interest

rates; (5) observations from financial institutions; (government (domestic or foreign) actions or pronouncements; and (7) other news events. For securities traded on foreign markets, the above factors might also include the value of foreign securities traded on other foreign markets, ADR trading, closed-end fund trading, foreign currency exchange activity, and the trading prices of financial products that are tied to baskets of foreign securities, such as WEBS. The letter states that these factors are merely illustrative and are not intended to preclude a board's consideration of any other factors. 2 board to determine, in good faith, the fair value price of the fund's securities. The letter suggests that in anticipation of emergency situations, such as the recent earthquake in Taiwan,² funds should consider adopting procedures that are designed to alert the board and fund management to conditions that may necessitate fair value pricing of portfolio securities.

Fair Value Pricing The staff's letter provides guidance on the fair value pricing process and discusses the factors fund boards should evaluate when fair value pricing a fund's portfolio securities. The letter reviews the guidance provided in Accounting Series Release Nos. 113 (restricted securities) and 118 (valuation issues generally), and notes that these releases, which continue to represent the views of the Commission, were intended to provide general illustrative guidance on certain valuation issues and were not intended to provide comprehensive guidance on how to address all pricing issues or emergency or unusual situations. The letter reaffirms that the "fair value" of a portfolio security is the price that a fund might reasonably expect to receive upon its current sale not what the fund might receive at some later time. The letter adds that while no single standard exists for determining fair value in good faith, as indicated in the Accounting Series Releases, fund boards should satisfy themselves that "all appropriate factors" have been considered, and should take into account "all indications of value available to them," when fair value pricing a portfolio security.³

The Board's "Good Faith" Responsibilities The staff's letter states that the number of factors that fund boards may need to evaluate when fair value pricing portfolio securities have increased significantly given the development of world financial markets, the proliferation of new financial products, and access to instantaneous communications. The letter recognizes, however, that funds boards typically are only indirectly involved in the day-to-day pricing of a fund's portfolio securities, and notes that most boards fulfill their obligations by reviewing and approving pricing methodologies, which may be formulated by the board, but more typically are recommended and applied by fund management. The letter suggests that funds may use a number of techniques to minimize the burdens of fair value pricing on their directors, such as delegating certain responsibilities for fair value pricing decisions to a valuation committee.

³The staff's letter notes that the degree of fund board involvement in satisfying its good faith obligations during emergencies will depend heavily on the comprehensiveness of the pricing procedures adopted for the fund and the degree of discretion vested in fund management. Thus, if a fund's board has approved comprehensive procedures that provide methodologies for how fund management should fair value price portfolio securities, including during such emergencies, it would need to have comparatively little involvement in the valuation process in order to satisfy its good faith obligation. On the other hand, the board's involvement must be "greater and more immediate" if it has vested a comparatively greater amount of discretion in fund management, or when pricing procedures are relatively vague. The letter notes that in any event, given that the fund's board retains oversight responsibility for the valuation of the fund's assets, the board should receive periodic reports from fund management that discuss the functioning of the valuation process and that focus on issues and valuation problems that have arisen.

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