INVESTMENT COMPANY INSTITUTE

MEMO# 13465

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ADDITIONAL SEC STAFF GUIDANCE REGARDING FUND PRICING OBLIGATIONS

[13465] May 1, 2001 TO: ACCOUNTING/TREASURERS MEMBERS No. 9-01 CLOSED-END INVESTMENT COMPANY MEMBERS No. 13-01 DIRECTOR SERVICES COMMITTEE No. 5-01 INTERNATIONAL MEMBERS No. 6-01 SEC RULES MEMBERS No. 37-01 SMALL FUNDS MEMBERS No. 12-01 UNIT INVESTMENT TRUST MEMBERS No. 16-01 RE: ADDITIONAL SEC STAFF GUIDANCE REGARDING FUND PRICING OBLIGATIONS The staff of the SEC's Division of Investment Management has issued a letter to the Institute following up on its December 1999 letter regarding fund pricing obligations.1 The letter provides the staff's views on the obligations of funds and their directors to determine the fair value of portfolio securities for which market quotations are not readily available and on other topics such as the valuation of securities traded on foreign exchanges and the inappropriate use of fair value pricing for securities for which market quotations are available. A copy of the letter is attached and it is summarized below. Fair Value Pricing and Significant Events The letter discusses the general requirements that funds calculate their net asset values (NAVs) by using the market prices of securities for which market quotations are "readily available" and, for securities that do not have readily available market quotations, using the fair value as determined in good faith by the fund's board. The letter notes that funds typically calculate their NAVs once each day at or near the close of the major U.S. securities exchanges, usually 4:00 p.m. Eastern time. The letter points out that many foreign markets operate at times that do not coincide with those of the major U.S. exchanges. As a result, the closing prices of securities that trade on foreign markets may be as much as 12-15 hours old by the time a fund calculates its NAV and 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 April 30, 2001. See Memorandum to Accounting/Treasurers Members No. 40-99, Closed-End Investment Company Members No. 48-99, International Members No. 28-99, SEC Rules Members No. 78-99 and Small Funds Members No. 18-99, dated December 13, 1999. The more recent letter states that the guidance provided in both letters applies to all investment companies regardless of their classification (e.g., open-end, closed-end) or investment objectives or strategies. 2may not reflect the current market values of those securities. The letter states that "[i]in particular, the closing prices of foreign securities may not reflect their market values at a fund's NAV calculation if an event that will affect the value of those securities ('significant event') has occurred since the closing prices were established on the foreign exchange or market, but before the fund's NAV calculation." The letter explains that the use of closing prices that were established before a "significant event" occurred may cause dilution in the value of shareholders' interests. It includes an exhibit designed to illustrate

that fair value pricing can protect long-term shareholders from short-term investors who seek to take advantage of arbitrage opportunities when “significant events” occur after a foreign exchange or market closes but before a fund calculates its NAV. The letter next addresses the availability of market quotations, summarizing funds’ obligations to consider various indications of the validity and reliability of market quotations in determining whether they are “readily available.” In the case of a foreign security, a fund must evaluate whether a “significant event” has occurred after the close of the foreign exchange or market but before the fund’s NAV calculation. If so, “the closing price for that security would not be considered a ‘readily available’ market quotation, and the fund must value the security pursuant to a fair value pricing methodology.” (The letter notes, however, that a determination that market quotations are not “readily available” would not preclude a fund’s board from concluding that the most recent closing market prices represent fair value, and states that closing prices generally should be considered along with other appropriate factors when making fair value determinations.) The letter indicates that this position applies equally to domestic securities. Accordingly, if a U.S. market closes early on a given day or regularly closes before a fund’s NAV calculation, and a “significant event” occurs between the closing of the market and the time of NAV calculation, a closing market price for a fund portfolio security would not be considered a “readily available” market quotation. The letter draws the same conclusion with respect to the use of the last quotations for a security prior to a trading halt, where trading in that security did not resume prior to the close of the exchange or market. The letter advises that consistent with their obligations under the 1940 Act, “funds should continuously monitor for events that might necessitate the use of fair value prices.” Whether a particular event is a “significant event” depends on whether it will affect the value of the fund’s portfolio securities. “Significant events” could include, among other things, “significant fluctuations in domestic or foreign markets.” Funds also should establish criteria for assessing the availability of market quotations. The letter cautions that “[f]unds that automatically use market quotations to calculate their NAVs, without first verifying that the market quotations are readily available, cannot be assured that the resulting NAVs are accurate.” The letter briefly discusses disclosure of fund valuation practices and expresses the staff’s view that funds and their shareholders would benefit from enhanced plain English disclosure of the use of fair value pricing and its effects. It recommends that funds that are more likely to use fair value pricing consider providing additional information to their 3shareholders – for example, in shareholder reports – and notes that such disclosure may result in fewer shareholder complaints about fair value pricing and may discourage arbitrage activity. Additional Matters Relating to Valuation The letter addresses the following additional topics: Ongoing Pricing Responsibilities. The letter reminds funds that they should review the appropriateness of pricing methods on an ongoing basis. For example, they should regularly test the accuracy of fair value prices by comparing them with values that are available from other sources and make any appropriate adjustments to their fair valuation methodologies. To evaluate the appropriateness of fair valuation methodologies for foreign securities, funds should review the next-day opening prices or actual sales prices of the securities on the foreign exchange or market. Appropriate measures also should be implemented to verify the accuracy of fair value prices obtained from pricing services. The Good Faith Requirement. Referring to a discussion in the staff’s 1999 letter of the requirement that fund boards determine, in “good faith,” the fair value of portfolio securities for which market quotations are not readily available, the letter provides additional guidance on the “good faith” requirement. It states the staff’s view that “a board acts in good faith when its fair value determination is the result of a sincere and honest assessment of the amount that the fund might reasonably expect to receive for a security upon its current sale, based upon all of the appropriate factors that are available to the fund.” The letter also provides several examples of what would not constitute acting in good faith and cites illustrative SEC enforcement proceedings. Trading Limits on Individual Foreign Securities. The letter addresses the valuation of foreign securities that are subject to trading limits or “collars” on the exchanges or markets on which they primarily trade. It states that funds must determine the fair value of their portfolio securities if the “limit up” or “limit down” prices of those securities have been reached and no trading has taken place at those prices. If trading has taken place, funds must consider whether market quotations are “readily available.” The Inappropriate Use of Fair Values when Market Quotations are Readily Available. The letter states that funds are not permitted to ignore readily available market quotations and instead fair value price portfolio securities. The staff believes funds must “exercise reasonable diligence to obtain market quotations for their portfolio securities before they may properly conclude that market quotations are not readily available.” For example, if market quotations from one source are determined to be unreliable, the fund should diligently seek to obtain market quotations from other sources before determining that market prices are not “readily available.” Frances M. Stadler Deputy Senior Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 13465. ICI Members may retrieve this memo and its attachment from ICINet (http://members.ici.org). 4Attachment (in .pdf format)
