

ICI VIEWPOINTS

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Mutual Fund Investments in Private Placements: an Overview

Given recent media interest in mutual fund investments in private placements, it might be helpful to review mutual fund disclosure and valuation obligations. How do funds handle securities that are not publicly traded?

Disclosure and Redemption

Mutual funds must publicly disclose their portfolio holdings on a quarterly basis, not more than 60 days after the period ends. In these disclosures, funds must identify by name each security owned at period end; the number of shares owned (for stocks) or the principal amount (for bonds); and the value of each security. Funds must flag each security that is restricted (i.e., not registered with the SEC under the Securities Act of 1933) and disclose the dollar amount and percentage of the portfolio that is invested in restricted securities. Certain funds may voluntarily disclose their portfolio holdings more frequently (e.g., monthly).

By law, mutual funds must pay redemption proceeds to redeeming shareholders within seven days. For this reason, they typically invest little, if any, of their assets in illiquid securities. In fact, long-standing SEC guidelines generally limit mutual funds from investing no more than 15 percent of their assets in securities that cannot be sold or disposed of within the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment.

Valuation

Mutual funds value their portfolio holdings daily, for purposes of calculating net asset value per share—the price at which investors buy into or sell out of the fund. For securities with readily available market prices (e.g., New York Stock Exchange-listed securities), funds use those prices. For other securities, funds make a good faith determination of the amount for which the security could be sold in a current transaction. Such a determination is called a fair value.

Funds may use a number of different methods to determine the fair value of a security with no readily available market price:

- Market-based methods include applying market-based multiples to historical or projected earnings or cash flows.
- Income-based methods include the discounted present value of future cash flows or capitalized free cash flows.
- Asset-based methods include the replacement cost of the company's assets or the

value of its tangible net assets in liquidation.

The fund's board of directors must approve the methods used to determine fair values. Because different funds can use different methods and inputs to value a private placement, it should not be surprising that different funds can derive different fair values for the same private placement.

A fund that has a material amount of its portfolio in private placements (a level that it determines, based on the facts and circumstances) must disclose in its financial statement the valuation method used. Generally accepted accounting principles require funds to categorize their portfolios into a three-level hierarchy and disclose the amount invested in each level:

- Level 1 represents securities with quoted prices in active markets.
- Level 2 represents securities valued through reference to other significant observable inputs, including such inputs as quoted prices for similar securities, interest rates, credit spreads, and prepayment speeds.
- Level 3 represents securities without observable inputs that are valued through reference to the fund's own assumptions.

Funds with a material amount of their portfolios in Level 3 investments must disclose in the notes to their financial statements the valuation methods used to value those investments, as well as the related inputs used and how changes in those inputs would affect the fair value.

Finally, it's important to keep in mind that a mutual fund's annual financial statements, including the value of its portfolio holdings, must be audited by an independent public accountant.