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for Mutual Fund Directors

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I. Introduction and Summary

Q. *Why is valuation so important?*

A. *It is the fundamental underpinning of the mutual fund concept (daily redeemability at NAV).*[1]

One of the principal advantages of mutual funds is the ease with which they can be bought and sold on a daily basis. This is accomplished because of the requirement under the Investment Company Act of 1940 (the "1940 Act") that a mutual fund[2] price and redeem its shares daily at their current net asset value ("NAV"). In order to calculate a current NAV for a fund, the fund must value each of its portfolio holdings every weekday. Under the 1940 Act:

- portfolio holdings "for which market quotations are readily available" must be valued at current "market value"
- all other portfolio holdings must be valued at "fair value as determined in good faith by the board of directors"

In 1940, valuation was fairly straightforward. Most mutual funds held domestic equity securities that were traded on the New York Stock Exchange ("NYSE"). Since then, markets have evolved. Mutual funds now hold municipal bonds, CMOs, SWAPs, emerging markets debt, etc., many of which do not have "readily available" market quotations. What was originally intended to be the exception (i.e., fair valuation by the board of directors) is now the rule for many types of funds (e.g., municipal bond funds). As a result, directors are often called upon to:

- adopt methodologies for the ongoing fair valuation of certain types of securities (e.g.; the use of a pricing service for municipal bonds);
- approve initial and ongoing fair values for restricted or other illiquid securities; and
- approve, on an emergency basis, a fair value for a particular security (or group of securities) in the event of a market break (e.g., a stock stops trading on the NYSE) or a significant event (e.g., an earthquake occurs in a local foreign market after that market closes, but before the time the fund determines its NAV).

[1] Valuation also has other important offshoots: (i) it often affects an adviser's compensation, since most mutual funds pay management fees on the basis of a fund's net assets; and (ii) it affects a fund's reported investment performance.

[2] Closed-end funds, even though they do not offer daily redemption, are also required to calculate their NAVs periodically.

In all these cases, it is important that the directors, in good faith, seek to determine a value that they reasonably expect the fund would receive for the securities in question upon their current sale.

Unlike other industries, where directors are often inclined to act "conservatively" (i.e., mark down the security in question), the directors of a mutual fund do not have that option. Proper and accurate valuation is critical to provide fairness to three groups: purchasing, redeeming and continuing shareholders.

- *Overvaluing assets results in purchasers being overcharged, while allowing redeeming shareholders to dilute the value of the shares held by remaining shareholders.*
- *Undervaluing assets results in redeeming shareholders being shortchanged, while giving purchasers more shares than they would have been entitled to receive.*

While the SEC has never gone so far as to bless a specific methodology for a board to use in fair valuing a security, the SEC and its staff have provided a series of releases and letters on the board's role in the process. Importantly, the SEC acknowledges that a board can approve a methodology or formula for certain types of securities rather than individually valuing each security on a daily basis. Nevertheless, the releases require that the board "continuously review the appropriateness of any method" so selected. In addition, the releases require the directors to "take into consideration all indications of value available to them in determining the 'fair value' assigned to a particular security" and "to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered."

II. The Regulatory Framework

A. Statutory and Regulatory Requirements

1. Section 22(c) and Rule 22c-1

Section 22(c) of the 1940 Act states that the SEC may adopt rules concerning the pricing of mutual fund shares. In accordance with that authority, the SEC has adopted Rule 22c-1, which provides that a mutual fund must price its shares at least once daily, each Monday through Friday, at the time (or times) of day determined by the board of directors, <u>except on</u>:

- customary national business holidays described or listed in the fund's prospectus;
- regional business holidays listed in the fund's prospectus;
- days on which changes in the value of fund's portfolio securities will not <u>materially</u> affect the current NAV of the fund; or
- days during which no purchase or redemption orders are received.

Historical Note

When Rule 22c-1 was originally adopted (in 1968),[3] *most mutual funds were primarily invested in domestic equity securities. As a result, that Rule originally was tied directly to the NYSE; requiring funds to price as of the close of the NYSE.*

In 1979, the SEC proposed that Rule 22c-1 be amended.[4] *Rather than require pricing at the close of the NYSE, the SEC proposed to require pricing at the close of each underlying security's primary trading market. Later in 1979, the SEC re-proposed,*[5] *and then adopted,*[6] *an amendment to Rule 22c-1, requiring funds to price their underlying securities on days when trading in the underlying securities might affect the fund's NAV. The effect of the 1979 amendments required certain international funds to price on Saturday or Sunday.*

In 1985, the SEC amended Rule 22c-1 to adopt the current version; requiring pricing only on weekdays (Monday through Friday), excluding certain holidays.[7]

2. Section 22(e)

Section 22(e) of the 1940 Act prohibits a mutual fund from suspending the right to redeem (or postpone payment for more than seven days), except:

- for any period during which the NYSE is closed;
- for any period during which trading on the NYSE is restricted;
- for any period during which the SEC declares that an emergency exists and the fund cannot reasonably (i) dispose of its securities or (ii) determine its NAV; or
- for any other periods as the SEC may permit.

[3] Investment Company Act Release No. 5413 (June 25, 1968) (proposing release); Investment Company Act Release No. 5519 (October 16, 1968) (adopting release).

[4] Investment Company Act Release No. 10545 (January 9, 1979).

[5] Investment Company Act Release No. 10691 (May 15, 1979). The re-proposing release initially required that the determination as to the time of day for pricing be approved by a separate vote of the independent directors. In response to harsh comments, the SEC's adopting release dropped the requirement for a separate vote by the independent directors.

[6] Investment Company Act Release No. 10827 (August 13, 1979).

[7] Investment Company Act Release No. 14244 (November 21, 1984) (proposing release); Investment Company Act Release No. 14559 (June 6, 1985) (adopting release).

In the 1985 amendments to Rule 22c-1,[8] the SEC also provided guidance regarding the ability of funds to suspend redemptions in emergency situations. The release indicated that when a fund is unable, because of emergency conditions, to complete the mechanical process of pricing on a day when it would normally be required to do so under Rule 22c-1, the price for that day may be calculated subsequently and applied to sales, redemptions and repurchases that were in fact received in the mail or otherwise on that same day. The release further states:

> "The fund is expected to make every effort to price investor orders for purchase and redemption on the day the order is actually received…and to establish procedures so as to reasonably be able, following an emergency closing, to insure that investor orders can be given the price that, but for the emergency, would have been computed on the day of actual receipt. … Nonetheless, if the fund is unable to segregate orders received on the emergency closed day from those received on the next day the fund is open for business, the fund may give all these orders the next price calculated after operations resume. This approach may be used where, for example, as a result of a snowstorm, local authorities declare a state of emergency, businesses are required to close, and only emergency travel is permitted. A fund relying on this exception…must process purchase orders on the same basis as requests for redemption."

3. Section 2(a)(41) and Rule 2a-4

Section 2(a)(41) of the 1940 Act, and Rule 2a-4 thereunder, provide that for purposes of calculating a mutual fund's NAV:

- securities "for which market quotations are readily available" must be valued at "market value"

- all other securities must be valued at "fair value as determined in good faith by the board of directors."

[8] Investment Company Act Release No. 14559 (June 6, 1985).

B. SEC Interpretative Guidance

1. ASR 113 (1969)

- *All restricted securities should be "fair valued."*
- *As a general principle, fair value is the amount that an owner might reasonably expect to receive upon a current sale.*
- *Restricted securities should be valued on a case-by-case basis. Automatic methods of fair valuation are generally not appropriate because they do not necessarily take into account all relevant factors. The SEC criticized each of the following "automatic methods":*
  - *Cost*
  - *Constant percentage or dollar discount to market price of the unrestricted public security*
  - *Amortized discount to market price over a period of time*

In 1969, the SEC became concerned about valuation practices[9] for restricted securities, and it issued the first of two accounting series releases on mutual fund valuation practices (ASR 113).[10]

ASR 113 was intended to address a then-current mutual fund practice of buying, at a discount, so-called "letter stock" (i.e., restricted shares from a company with public stock). Quite often, the funds immediately, or shortly, raised the price of their "letter stock" holdings to the current market value of the company's unrestricted public stock.

The SEC stated that since readily available market quotations, by definition, referred only to current "public" quotations, restricted securities (since they were not public) must be fair valued by a fund's board of directors. As a general principle, the SEC observed that current fair value of restricted securities appeared to be the amount that the owner might reasonably expect to receive upon a current sale. In light of this principle, the SEC said that valuing restricted securities at the same price as the issuer's unrestricted securities would generally be improper. Moreover, the SEC said that automatic methods of valuing restricted securities were not appropriate, since such methods do not consider all relevant facts. The SEC cited, as examples of such automatic methods: (i) the use of cost; (ii) applying a constant percentage or dollar discount to the market price of the unrestricted public security; and (iii) amortizing the difference between cost and the market price of the unrestricted public security over some chosen period of time.

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[9] The SEC noted the critical importance of the valuation process. Valuation affects: (i) the price at which fund shares are sold and redeemed; (ii) the compensation to investment advisers who are paid on the basis of net asset value; and (iii) the fund's reported investment performance.

[10] Investment Company Act Release No. 5487; Accounting Series Release No. 113 (October 21, 1969).

ASR 113 also advised that: (i) the data and information considered by the directors in their fair valuation analysis should be retained and available for inspection by the fund's auditors; (ii) the directors must continuously review the appropriateness of any valuation method used; and (iii) the actual valuation calculations could be made by persons acting pursuant to the direction of the board.

2. ASR 118 (1970)

- *Exchange-Traded Securities*
  - *Last sale on principal exchange.*
  - *If no last sale on principal exchange, then last sale on any other exchange.*
  - *If no last sale, then value within the range of published closing bid and asked prices.*
    - *typically bid, or mean between bid and asked prices.*
    - *asked price alone is not normally acceptable.*
- *OTC Securities*
  - *Value within the range of bid and asked prices.*
  - *Ordinarily, quotations should be obtained from more than one broker-dealer (particularly if quotations are only available from broker-dealers who are not market-makers).*
- *If market quotations are available, but considered to be unreliable, then the security should be "fair valued."*
- *Fair Valued Securities*
  - *"Fair value" must be determined in good faith by the board of directors.*
  - *Fair value is the amount an owner "might reasonably expect to receive upon a current sale."*
  - *The directors may appoint persons to assist them in determining fair value (and to make actual calculations pursuant to the board's direction).*
  - *The directors must continuously review the appropriateness of any method used to fair value a security.*
  - *Fair value decisions, and the basis upon which they were made, should be documented in the minutes.*

Approximately one year after it issued its first accounting series release on valuation (ASR 113), the SEC issued its second release (ASR 118).[11] ASR 118 expands upon ASR 113 and provides more general guidance regarding the board's role in the valuation process. It broadly directs the board to "take into consideration all indications of value available to them in determining the 'fair value' assigned to a particular security" and requires the directors "to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered." ASR 118 also laid out the general framework for valuing publicly traded listed and OTC securities.

[11] Investment Company Act Release No. 6295; Accounting Series Release No. 118 (December 23, 1970)

a. Market Quotations for Listed and OTC Securities

Under ASR 118, funds are instructed "generally" to use the last quoted sales price as of the time of valuation.[12] For securities that are listed on more than one exchange, ASR 118 indicates that funds should use the last sales price from the exchange on which the security is principally traded, and that last sales information from other exchanges should be used only when there are no trades reported on the primary exchange on a given date.

When there is no quoted sales information for a given date, ASR 118 contemplates the use of bid and asked prices quoted by broker-dealers. ASR 118 states that "ordinarily," quotations should be obtained from more than one broker-dealer, "particularly if quotations are available only from broker-dealers not known to be established market-makers for that security."

Funds are allowed discretion to use any of several methods involving means of bid prices, bid and asked prices, or broker-dealer prices. Use of asked prices alone normally is not acceptable. ASR 118 states:

> "A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoting on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in the circumstances. Any of these policies is acceptable if consistently applied.[13]"

ASR 118 cites several instances in which "further consideration" should be given as to whether market quotations should be deemed not "readily available," and thus inappropriate for determining market value. These include instances in which there is only a "thin market" for a security or, in the case of OTC securities, where the validity of the broker-dealer quotations "appears questionable."

b. Fair Value

When there are no "readily available market quotations" for a security, funds must employ "fair value" methodologies to price the security. ASR 118 states that, "[a]s a general principle," fair value "would appear to be" the amount that the owner "might reasonably except to receive . . . upon a current sale."

The SEC, recognizing that there is no single method for determining fair value, set forth a non-exclusive list of acceptable bases for valuation methods, and specific and general factors that

[12] ASR 118 recognizes that sometimes "value can be determined fairly in more than one way." Therefore, the ASR 118 rules for listed and OTC securities are called "guidelines." Nevertheless, ASR 118 requires that "any variation" from the guidelines be disclosed in the fund's financial statements or the notes thereto "even though the variation is in accordance with the company's stated valuation policy."

[13] Conversely, funds holding short positions in OTC securities can value them using the asked or the mean between bid and asked quotations, but using the bid alone would be inappropriate.

boards of directors should consider in determining a valuation method, and suggested that directors use good judgment and take into consideration all indications of value available to them. This list indicates that methodologies could be based upon: (i) a multiple of earnings; (ii) a discount from market of a similar freely traded security; (iii) with respect to debt instruments, the yield to maturity; or (iv) a combination of the foregoing. The factors that ASR 118 indicates are among those that should be considered in determining fair value methods include:

- fundamental analytical data
- the nature and duration of restrictions on disposition
- an evaluation of the forces that influence the market in which the securities are purchased and sold
- other specific factors, including:
    - type of security
    - financial statements
    - cost
    - size of holding
    - analysts' reports
    - transactional information or offers
    - public trading in similar securities of the issuer or comparable companies

As in ASR 113, the SEC again emphasized that: (i) the data and information considered by the directors in their fair valuation analysis should be retained and available for inspection by the auditors; (ii) directors have a responsibility to "continuously" review the appropriateness of any valuation method used; and (iii) the directors may appoint persons to assist them in their fair value determinations and to make the actual calculations.

- *What does "continuously" mean?*
    - *It means don't just look at it once and then never again.*
    - *In the <u>Mates Financial Services</u> enforcement action (3/9/70), the SEC characterized this as being at "appropriate intervals."*
    - *In the <u>Seaboard Associates</u> enforcement action (4/16/84), the SEC said that problems arise when the directors do not "exercise adequate care in monitoring" fair valued securities.*

3. SEC Staff Letter (1999)

- *If market quotations are unreliable, they cannot be considered "readily available," and the fund should use fair value pricing.*
- *Funds should adopt procedures that are designed to alert the board to conditions that may necessitate fair value pricing.*
- *Fair value is the price a fund might reasonably expect to receive upon a current sale.*
  - *It is not a price based upon what a buyer might pay at some later time.*
- *A valuation committee may be used to "assist" the board in its fair valuation responsibilities.*
- *The board should receive "periodic" reports on the valuation process and any valuation problems that have arisen.*

In 1999, in anticipation of Y2K, the SEC staff issued a letter reviewing the obligations of mutual funds to price and redeem their shares during emergency or unusual situations.[14] In addition, the letter expanded upon the general guidance provided by ASR 113 and ASR 118 on fair value pricing, and also discussed measures that directors may take when discharging their fair valuation responsibilities.

The letter noted that there may be instances when the last available market quotation is unreliable, and therefore should not be considered "readily available." For example, following a 1999 earthquake in Taiwan, the Taiwan Stock Exchange was closed for a number of days. Under such a circumstance, market quotations for securities traded on the Taiwan Stock Exchange were not "readily available" and funds were required to use fair value pricing.[15] The letter stated that funds should consider adopting procedures that are designed to alert the board to conditions that may necessitate fair value pricing.

With respect to fair value pricing, the letter reaffirmed the general guidance set forth in ASR 113 and ASR 118, stating that fair value is the price that the fund might reasonably expect to receive upon a "current sale." It is not intended, under ordinary conditions, to represent an immediate "fire sale" disposition, but rather what the fund would reasonably expect to receive from a sale in the normal course of business to an arm's-length buyer.[16] It is also not a price

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[14] 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 (December 8, 1999).

[15] The letter notes that funds are not precluded from using the last available market quotations in such events, but states that such a result should be the result of consideration of all appropriate factors, including the last available market quotations. In addition, the letter said that funds should not treat all securities the same. By way of example, a fund should not simply mark down all holdings by 10%.

[16] If a fund is aware of circumstances that would require it to dispose of a security on a "fire sale" basis, however, it may be appropriate to value the security on that basis.

based upon what a buyer might pay at some later time; nor can it be based upon the premise that the fund does not currently intend or need to sell the securities (e.g., a fund may not fair value a bond at par based upon the expectation of holding the bond until maturity).[17]

The letter recognized the complexity of fair valuing securities, and noted that different boards, when fair valuing identical securities, could reasonably arrive at different prices.[18] The letter also recognized that funds may use valuation committees to "assist the board in developing fair valuation methodologies" and to "implement the board-approved methodologies on a day-to-day basis." As with the accounting series releases, the letter noted the necessity of "periodic" board review of the fair valuation methodologies used. It also suggested that "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."

4. SEC Staff Letter (2001)

- *If there is a "significant event" between the time of a market quotation and the time when the fund determines its NAV, the fund must fair value its affected securities.*
- *Funds should review the appropriateness of fair value pricing methods on an "ongoing basis."*
- *The "good faith" requirement for directors is met when directors act sincerely and honestly in seeking to determine the price that the fund might reasonably expect to receive for a security upon its current sale.*

In 2001, the SEC staff issued a follow-up to its 1999 letter.[19] The letter introduced the term "significant event" for determining when market quotations are not reliable, and, therefore, for when fair value pricing should be used. It also clarified the SEC staff's views on other valuation issues, including the directors' "good faith" responsibilities in fair value pricing.

The letter noted that most funds price their securities at 4:00 p.m. (Eastern Time), using closing prices from exchanges or other markets. In certain instances, particularly in foreign markets, the time between the closing prices and the fund's 4:00 p.m. pricing time can be substantial (e.g., 12-15 hours), and those closing prices may no longer reflect their current market values as of 4:00 p.m. Moreover, if there has been a "significant event" during this

[17] Under prescribed circumstances, funds can, however, value debt securities with remaining maturities of 60 days or less at their amortized cost. *See* Accounting Series Release No. 219 (May 31, 1977).

[18] The letters stated, however, that the staff did not believe that the same board could, in good faith, arrive at different fair valuations for identical securities held by two or more funds that the board oversees.

[19] 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 (April 30, 2001).

period, the letter states that the fund must fair value its affected securities.[20] The letter defines a "significant event" as "an event that will affect the value of a portfolio security."

The letter says that funds should continuously monitor for events that might necessitate the use of fair value prices and establish criteria for determining whether market quotations are readily available. The letter suggests that funds assess the availability of market quotations each day.

The 2001 letter does not provide for any materiality threshold to be used in determining whether to apply fair value pricing following a significant event. This approach ignores reality.

- *SEC definition –*
    - *"An event that will affect the value of a portfolio security"*
- *Practical definition – Two factors (probability and magnitude)*
    - *Probability – The event "will" affect the value of a portfolio security*
        - *This definition has, in essence, a materiality standard imbedded within it. (It is not an event that may affect the value of a portfolio security.)*
- *Magnitude – The effect will be material*
    - *the effect on the value of the portfolio security*
    - *the effect on the NAV of the fund (e.g., at least ½ of 1%)*
- *Authority*
    - *Paul Revere Investors, Inc. no-action letter (3/22/73)*
        - *Fund can continue to use normal pricing convention (without going back to the board to fair value) unless the valuation committee believes that it would affect the Fund's NAV by 1%.*
    - *SEC v. Steadman (1992)*
        - *A penny per share is not per se material.*
    - *Rule 22c-1*
        - *A fund is not required to price on days on which changes in the value of its portfolio securities will not materially affect the current NAV.*

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

[20] The letter also discusses the effects of arbitrage activity on mutual funds. It states that by not fair valuing in the case of significant events, a fund is susceptible to arbitrage activity, which can greatly dilute the value of shareholders' interests.

prices obtained from pricing services, such as using secondary pricing services and comparing valuations to actual sales prices.

The Good Faith Requirement. With respect to 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 states that a board generally would not be acting in good faith if it knows or has reason to believe that its fair value determination does not reflect the amount that the fund might reasonably expect to receive for the security upon its current sale, or if the board acts with reckless disregard in making its determination.

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 no 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 that 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."

C. SEC Actions

1. Adviser Supervision

a. Van Kampen American Capital (1995)

In 1995, the SEC sanctioned Van Kampen American Capital Asset Management, Inc.[21] for failure to supervise a portfolio manager who "hand priced" various CMO holdings in the fund's portfolio at substantially inflated values.

The SEC determined that Thomas M. Rogge, a mutual fund portfolio manager, had intentionally mispriced various CMO holdings during a period from August 4 to August 26,

[21] *Van Kampen American Capital Asset Management, Inc.*, Investment Advisers Act Release No. 1525 (September 29, 1995).

1993 in an attempt to conceal their declining value.[22] By the time the adviser discovered the scheme on August 27, 1993, the securities were overvalued by $6.88 million and the fund's NAV was inflated by 76 cents per share. As a result, the SEC sanctioned the adviser for failure to reasonably supervise Rogge's actions.

The SEC's order indicated that the adviser:

> had no written procedures to implement the Fund's policy to use bid side market prices for valuing securities. . . The firm's practices concerning the daily pricing of the portfolio were insufficient in that they, among other things, gave [the portfolio manager] too much control over the pricing process with little or no oversight by anyone in a supervisory capacity. In addition, there was no procedure in place to alert [the adviser] when bid side market prices for securities were not available. [The adviser] did not independently verify the daily prices provided to [the adviser's] accounting department with the pricing source or any secondary sources.

b. Mitchell Hutchins (1997)

In 1997, the SEC sanctioned Mitchell Hutchins Asset Management, Inc.[23] for failure to supervise a portfolio manager who frequently overrode the prices received from the fund's pricing service and instead substituted his own prices.

Similar to the Van Kampen enforcement action discussed above, the portfolio manager in this case purchased a number of CMOs and then attempted to mask their declining value. Pursuant to the fund's valuation procedures, the CMOs were to be valued using prices received from the fund's pricing service (or from a broker-dealer). The procedures, however, permitted the portfolio manager to substitute his own price if he determined that the price received from the pricing service did not adequately reflect a security's "fair value." The adviser, though, had no written procedures to guide the portfolio manager in making those pricing determinations. Moreover, the adviser did not have in place any process to review the effect of the portfolio manager's actions in overriding prices. Indeed, the adviser's chief investment officer, who reviewed and initialed price overrides, reported to the general counsel that the portfolio manager's overrides were "persistent" and "high" in number. In addition, he reported that the portfolio manager's override documentation did not provide sufficient information to review the basis for the override. The general counsel reported this information to the firm's president. Four months following the CIO's report, the adviser held an internal meeting to discuss price overrides. Following this meeting, the CIO refused to initial any additional overrides. The

[22] Mr. Rogge had earlier been sanctioned by the SEC for his actions. *In the Matter of Thomas M. Rogue*, Investment Advisers Act Release No. 1472 (February 22, 1995).

[23] *In the Matter of Mitchell Hutchins Asset Management, Inc.*, Investment Advisers Act Release No. 1654 (September 2, 1997).

adviser, however, still did not investigate the portfolio manager's override practices until a month later.

The SEC's order cited the adviser for acting recklessly with respect to its supervision of the pricing process. The SEC noted, in particular, that despite an earlier indication that might have led the firm to discover the portfolio manager's improper overriding of prices, the adviser did not review his override practices until sometime later.

c. Piper Capital Management (2000)

In 2000, an SEC administrative law judge sanctioned Piper Capital Management Incorporated and certain of its senior executives and employees for violations of the securities laws related to their purchase of and subsequent valuation activities related to various CMOs.[24]

To value various CMOs held by the fund, the adviser engaged a pricing service, JJ Kenny, to provide daily valuations. Although Kenny transmitted prices to the adviser on a daily basis, effectively, Kenny only adjusted the prices of the CMOs once a week (on Thursday). On March 31, 1994, during the midst of the CMO-market crash, the adviser discovered that the prices received from Kenny were "stale." From March 31, 1994 to April 8, 1994, the pricing of the fund was extremely difficult. Nevertheless, it was clear that on April 4, 1994 (the next business day) the prices were unrealistically high. Rather than immediately mark down the CMOs to a more realistic level, certain of the advisor's senior executives and employees conspired to "ratchet down" the price over a few days, rather than take the hit all on one day. The SEC administrative law judge viewed this conduct as "reckless," and found the parties to have violated the federal securities laws, including the NAV pricing requirements of Section 22(c) and Rule 22c-1.

The SEC administrative law judge, however, did not fault the parties for failing to discover, prior to March 31, 1994, that the prices provided by Kenny were "stale." The SEC administrative law judge stated that Kenny was a "reputable/highly regarded pricing service. . . on whose quotes it was *prima facie* reasonable for [the fund] to rely."

Among the parties whom the SEC staff actively pursued, and the SEC administrative law judge found to have violated the federal securities laws, was a relatively low-level employee who served as an accounting manager in the adviser's operations department. The SEC and the SEC administrative law judge seemed to believe that this person could have refused to participate in the decision of her immediate supervisors and other senior executives to gradually lower the prices of the CMOs in question.

d. Legg Mason (2001)

In September 2001, the SEC sanctioned Western Asset Management Co. (the "sub-adviser") and Legg Mason Fund Adviser, Inc. (the "adviser") for failure to supervise a portfolio

[24] *In the Matter of Piper Capital Management, Inc., Worth V. Bruntjen, Marijo A. Goldstein, Robert H. Nelson, Amy K. Johnson, Molly Destro, and Edward J. Kohler*, Initial Dec. 175, (November 30, 2000).

manager of a high-yield bond who (i) concealed that certain portfolio holdings of the fund were suffering severe financial problems; and (ii) inflated the value of the troubled securities, which caused the fund to materially overstate its net asset value.[25]

In this situation, the adviser to a high-yield bond fund employed a sub-adviser to manage the fund.[26] The sub-adviser employed a portfolio manager. From July 1994 through April 1998, the portfolio manager purchased a number of high-yield bonds in private placement transactions through a particular broker-dealer. For such securities, the fund's pricing procedures called for the use of quotes from two brokers. The portfolio manager, however, could not obtain two broker quotes. Rather, she entered in the fund's pricing sheets two fictional quotes based upon discussions with the broker-dealer that sold her the securities.

Subsequent to purchasing the securities the issuers encountered severe financial problems and defaulted on their interest payments. Neither the portfolio manager nor the broker-dealer lowered the quotes on these securities. Rather, the portfolio manager and the broker-dealer entered into roll-up transactions to mask the problems. (A principal of the broker-dealer created a shell company, which sold new securities to the fund. The shell company then used the proceeds of the new securities to purchase the problem securities from the fund.) The SEC estimated that the inflated pricing ranged from $0.09 to $0.20, or from 0.52% to 1.33%, per share, which the SEC said was material.

The SEC sanctioned the sub-adviser (which employed the portfolio manager) for failure to reasonably supervise the portfolio manager. Moreover, the SEC also sanctioned the adviser, which employed the sub-adviser, also for failure to supervise the portfolio manager. The SEC said that the written sub-advisory agreement between the adviser and the sub-adviser specifically stated that the sub-adviser's provision of sub-advisory services was subject to the supervision of the adviser. The SEC also said that the adviser had indications of irregularities regarding the problem securities (e.g., despite interest payment defaults, the prices for the securities were not reduced).

The SEC said that:

> "Despite the irregularities regarding the notes and their pricing, [the adviser] did not do any investigation beyond confirming with the Portfolio Manager and the Broker-Dealer (who had underwritten the problem notes) that their pricing and pricing procedures included obtaining two broker quotes. Had [the adviser] conducted any independent investigation, it should have discovered that the Portfolio Manager's and the Broker-Dealer's confirmations were false, that they did not obtain prices from two

[25] *In the Matter of Western Asset Management Co. and Legg Mason Fund Adviser, Inc.*, Investment Advisers Act Release No. 1980 (September 28, 2001).

[26] Although the adviser and sub-adviser were affiliated entities, the SEC order did not highlight the affiliation as a key fact.

> brokers, that the issuers were in severe financial condition, that their prices were overstated and that the current pricing did not comply with the Funds' policies or disclosure."

This enforcement action is particularly interesting in that it sanctioned a party (i.e., the adviser) with indirect supervisory responsibility (not unlike the supervisory responsibility that a fund's board of directors has over the adviser). In addition, this action articulated the SEC's view that a pricing error of at least 0.52% is material.

2. Director Valuation Responsibilities

a. Mates Financial Services (1970)

On the heels of ASR 113 (released in 1969), the SEC brought its first enforcement case for abuses of valuing "letter stock." In 1970, the SEC sanctioned, among others, Frederick S. Mates, the sole proprietor of an investment adviser to a mutual fund, for improperly valuing the "letter stock" restricted securities held by the fund.[27]

In 1968, Mr. Mates, as president of the fund, stated in the fund's financial report:

> "In recent months, there has been a tendency among several mutual funds to take positions via 'investment letter' directly from the issuing companies or principal stockholders. This limits the liquidity of these positions since the shares so purchased must be registered with the Securities & Exchange Commission or held for a period of time before they can be resold to the public. Since 'investment letter' stock is generally available at a substantial discount from market, mutual funds which engage in this sort of activity can show quite remarkable results over the shorter term. Although we would not hesitate to step off the beaten path in search of unusual investment values, we believe that deliberately locking oneself into a position delegates too much of management's responsibilities to the vagaries of the market. Thus, you may be pleased to know that there is nothing in our portfolio that we could not sell immediately if we so choose."

Despite the representations in the letter, Mates acquired for the fund substantial amounts of various issues of restricted securities. Six of those issues, which had an aggregate cost of $3,610,000, were assigned an initial value of $7,161,250. Four of the six securities were valued at the market price for unrestricted securities of the same issuer and class. The other two were valued pursuant to certain methods that had the effect of a constant dollar discount from the fluctuating market price for the corresponding unrestricted shares.

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[27] *In the Matter of Mates Financial Services, Mates Management Company, Frederick S. Mates,* Investment Advisers Act Release No. 258 (March 9, 1970).

Although the fund directors were not sanctioned, the SEC stated that a mutual fund's board of directors has a "continuing obligation" to determine the fair value of restricted securities at "appropriate intervals." In this case, the SEC stated that the directors "did not even purport to value the Fund's holdings." Rather, they were advised of Mate's valuation methods and "made no objections."

b. Seaboard Associates (1984)

In 1984, the SEC issued a report under its "Section 21(a) powers" with respect to Seaboard Associates, Inc.[28] The SEC stated that the purpose of the report was to emphasize "the responsibilities of investment company directors to value those assets of a fund not having a readily ascertainable market value."

Seaboard was a closed-end fund that held, as its most significant asset, an interest in Metropolitan Royalty Corporation (which held oil and gas royalty interests in various properties).

Prior to 1972, the fund valued its interest in Metropolitan at "cost." In 1972, the fund re-valued its holding in Metropolitan at a "fair value" of $1.2 million based upon an appraisal by a recognized engineering firm.

In 1974, the fund's auditors suggested that the fund consider revaluing its interest in Metropolitan in light of dramatic increases in oil prices due to the OPEC oil embargo. The directors of the fund, however, concluded that "the extraordinary events in the oil markets are too recent and the world oil situation too unsettled to justify a revaluation at that time." As a result, the auditors issued a "qualified" opinion.

Later in 1974, the auditors again advised the fund that it should consider revaluation of Metropolitan. This time, the auditors proposed a formula to the directors, which adjusted the 1972 appraised value. The directors accepted the formula and continued to use it through 1979. Nevertheless, the auditors continued to issue qualified opinions during the period. According to the SEC, during this period the directors "did not question whether [the fund's] procedures for the determination of fair value or the continued use of the computation were appropriate. They relied on the auditors notwithstanding the fact that the auditors' opinions, during this period, . . . were qualified. . ." In 1975, the fund's directors received an engineer's written opinion that indicated that Metropolitan's oil royalties, based upon increased utilization, would substantially increase. Still, the directors took no action to revalue the fund's interest in Metropolitan.

In 1978, the fund made a tender offer for its shares at a price of $26.00 per share, a $3.74 premium over its $22.26 NAV. During the tender offer, one fund shareholder wrote a letter to the fund claiming that it was undervaluing its interest in Metropolitan and offered to purchase

[28] *In the Matter of Seaboard Associates, Inc.*, Investment Company Act Release No. 13890 (April 16, 1984). Under Section 21(a) of the Securities Exchange Act of 1934, the SEC is authorized, in its discretion, to publish information that it gathers during any investigation that it believes is necessary or proper to report to the public.

Metropolitan from the fund at a substantially higher price. The directors rejected the offer and did not seek to revalue Metropolitan, but rather continued with the tender offer.

After completion of the tender offer, in 1980, the fund's directors authorized a reappraisal of Metropolitan's assets. Based upon that reappraisal, the directors substantially increased the "fair value" of Metropolitan, resulting in an NAV increase from $23.18 to $58.84 per share.

Although the SEC did not sanction the directors, in its report, the SEC emphasized that directors must "exercise adequate care in monitoring the fair value of assets not having a readily ascertainable market value" and that the board "must continuously review the appropriateness of the method used in valuing the assets not having a readily ascertainable market value." The directors "were not justified in continued reliance on the 1972 appraisal as adjusted. The auditors' repeated qualification of their opinion. . . should have alerted the [fund's] directors that they could not rely solely on the auditors to provide an accurate valuation of the oil royalty interests," particularly in light of the other facts presented and available to the directors.

Finally, the SEC emphasized that directors "may not delegate to others the ultimate responsibility" for fair valuation.

c. Corporate Capital Resources (1993)

In 1993, the SEC sanctioned four directors of Corporate Capital Resources, Inc.[29]

- Daniel D. Weston[30]
  - Chairman of the Board of the fund
  - Valuation Committee member

- Lloyd Blonder[31]
  - Director of the fund
  - Valuation Committee member

- William P. Hartl[32]
  - Director of the fund

- Eric P. Lipman[33]
  - Director of the fund

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[29] Corporate Capital Resources was a business development company ("BDC"), a type of closed-end investment company that invests exclusively in small businesses to which the fund offers managerial assistance as well as capital investment. BDCs are governed by Sections 54 through 65 of the 1940 Act and are subject to most other provisions of the 1940 Act, including the valuation standards of Section 2(a)(41).

[30] *In the Matter of Daniel D. Weston,* Investment Company Act Release No. 19754 (September 30, 1993).

[31] *In the Matter of Lloyd Blonder,* Investment Company Act Release No. 19755 (September 30, 1993).

[32] *In the Matter of William P. Hartl and Eric P. Lipman,* Investment Company Act Release No. 19840 (November 8, 1993).

This fund held large positions of securities acquired (or allegedly acquired)[34] directly from issuers of thinly traded public stock. To value the holdings, the fund used "pink sheet" indications of interest for the public securities, less a haircut. In many instances, this resulted in an immediate twenty-fold increase from cost.[35] The SEC claimed that those valuations were flawed because:

- the "pink sheet" indications were not firm as to quantity of shares, let alone the large positions held by the fund;

- the method wholly ignored the underlying financial condition and business prospects of the companies; and

- most of the companies were unprofitable, insolvent or both.

The SEC claimed that Weston, acting alone, drafted and implemented the fund's valuation policies. Although he prepared quarterly valuation sheets containing the pink sheet quotes and other information to support the proposed valuations, the record did not support any meaningful review of the information by the valuation committee members.

- They did not hold any regular meetings.

- They did not conduct any independent research to determine if Weston's proposed valuations were fair and reasonable.

- They did not review any financial information about the companies.

- They did not consider the large blocks of the securities held by the fund and the ability to dispose of such large blocks in an orderly manner.

- They did not inquire about the prices and extent of public trading in similar securities of the issuer or comparable companies.

- They routinely approved the valuations proposed by Weston.

Moreover, the other directors did not have any knowledge as to how the valuation committee valued the holdings and had no role in the valuation process other than to routinely approve the valuation committee's recommendations. Although the fund's valuation procedures allowed the directors to delegate to the valuation committee the primary work of forming

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[33] *In the Matter of William P. Hartl and Eric P. Lipman,* Investment Company Act Release No. 19840 (November 8, 1993).

[34] In certain cases, it was questionable whether the fund had any legitimate interest in the securities. It appeared that the fund had only entered into executory contracts with the companies.

[35] For example, on June 30, 1989, the fund acquired a 48.2% ownership of a company for a $600,000 promissory note. On that same day, the fund valued the holding at $3,500,000.

valuation recommendations, it did not absolve the directors "from all involvement in the valuation process. Each director was still required to, in 'good faith,' consider and vote upon the 'fair value' assigned to [the fund's] restricted securities."

d. Parnassus (1998)

In 1998, an SEC administrative law judge sanctioned, among others, the independent trustees of the Parnassus Fund for failure to satisfy their fair value responsibilities.[36]

The *Parnassus* case involved a fund holding called "Margaux, Inc.," a thinly traded security. After purchase by the fund, Margaux was delisted from the NASDAQ Stock Market. The last available NASDAQ "market quote" for Margaux shares was $0.34 per share.

After Margaux was delisted, it traded on the "pink sheets," at $0.03 a share. During the four month period after Margaux was delisted, the actual sales price of Margaux shares dropped to as little as $0.01 per share. Margaux itself reported that it believed the 'fair market value' of its shares was $0.13 per share.

The fund's trustees, however, valued the Margaux common stock at $0.34 per share for the next two years. In their response to the SEC's actions, the trustees claimed that they regularly reviewed the company and the price and made a decision, in good faith, that the company had a great technology which was worth more than $0.03 per share. The stock price eventually came back up and was sold for $0.28 per share.

Nonetheless, the SEC administrative law judge found that the trustees failed to act in good faith when valuing the Margaux shares because they "ignored or failed to give adequate consideration" to relevant factors and information when making their pricing decisions, including Margaux's own unfavorable financial data as well as a nationally televised negative report about Margaux's largest customer.

The SEC administrative law judge found that the trustees valued the Margaux holdings without carefully considering and documenting in the meeting minutes certain significant factors. The following factors contributed to the finding that the trustees failed to fair value the Margaux holdings in good faith:

- The trustees' failure to "carefully consider or document the implications of Margaux's NASDAQ delisting;"
- The trustees' failure to give "meaningful attention" to Margaux's own unfavorable financial data, which the trustees had access to and discussed;
- The adviser's comment that current earnings were not "key things," a comment which the SEC found to be "indicative of [the trustees'] general failure to accord meaningful and necessary attention to Margaux's . . . financial statements;"

[36] *Parnassus Investments, et al.*, Initial Dec. No. 131 (September 3, 1998), Initial Dec. Final (October 3, 1998).

- The trustees' failure to give adequate consideration to the transactions and bid and asked prices on the "pink sheets;"

- The trustees' use of a valuation methodology which anticipated a future sale of Margaux while ignoring the decided lack of interest in Margaux among outside suitors; and

- The trustees' failure to adequately consider the impact on Margaux of a nationally televised negative report concerning Margaux's largest customer.

e. The Rockies Fund (2001)

In 2001,[37] an SEC administrative law judge sanctioned, among others, the independent directors of The Rockies Fund[38] for inappropriately fair valuing certain of the fund's restricted portfolio securities as if they were not restricted.

In 1991, Stephen Calandrella purchased more than 30% of the fund's shares and assumed management of the fund. In 1992, Calandrella obtained a personal interest in Premier Concepts, Inc. ("Premier"), which was involved in the operation and acquisition of costume jewelry stores. As part of a private placement to provide Premier with sufficient capital to make a particular acquisition, the fund (at Calandrella's direction) purchased restricted securities of Premier. In addition, the fund received additional warrants for equity securities of Premier (which warrants were also restricted) in return for a loan commitment the fund made to Premier. The fund's holdings of Premier constituted approximately 28% of the fund's portfolio. Over the course of the next two years, Calandrella and a business associate at another BDC engaged in the manipulation of Premier stock in the over-the-counter market for their own personal gain. As a result of the SEC's investigation and enforcement proceedings, the fund sold all its Premier holdings back to Premier in 1996.

During the period from June 1994 through December 1995 the fund filed eight financial reports with the SEC. In each of these reports, the fund valued its large holdings of restricted Premier securities at the same per-share price as it valued its smaller holdings of unrestricted Premier common stock. Furthermore, all Premier securities were systematically valued at or above the bid prices received from market makers in Premier common stock, which bid prices were largely the result of Calandrella's manipulations. This practice was in violation of both the board's obligation to value the restricted securities at fair value and the fund prospectus, which stated that restricted securities would be carried at cost, unless the board concluded that events indicated another value was appropriate. The administrative law judge found that:

> "There is no evidence to support [the directors'] claim that investments in restricted securities were carried at estimated fair

[37] *In the Matter of the Rockies Fund, Inc., et al.*, Initial Dec. 181 (March 9, 2001), Order Granting Petition for Review (April 16, 2001).

[38] The Rockies Fund was a business development company.

> value as determined in good faith by the Board. There is absolutely no documentation of any board deliberations . . . The documentation for the Fund's quarterly valuations of its portfolio consists of a two-page form, "Consent Resolutions," by which the board ratified, adopted, and approved the valuations of securities proposed by Respondent Calandrella. Attached to each consent resolution as Exhibit A is a list of the approximately twenty-five securities in the Fund's portfolio with one or two sentences about each security stating the per share value. This is all the written material the board received on valuations.
>
> The record is devoid of any documentation or other evidence to support [the directors'] position that the Fund's board valued Premier and each holding in the portfolio in good faith based on discussions of a wide range of factors, and that these discussions occurred on telephone calls or at face-to-face meetings . . . [The directors] made general claims that they could not support with specific facts. No one had any notes or specific recollection of any meeting they had attended. [The directors'] testimony on this issue was inconsistent and unpersuasive. Respondents Thygesen and Powell could not remember details of any discussion about Premier in 1994 or 1995. Respondent Thygesen could not recall ever changing a value proposed by Respondent Calandrella . . . Respondent Thygesen admitted, and Respondent Powell admitted and denied, that (1) if there was a market price for the stock there was no discussion as to its value, (2) unrestricted securities were generally valued at market price, and (3) the board valued restricted shares of Premier the same way they valued unrestricted securities. These admissions and the evidence taken as a whole establish that [the directors'] valued the Fund's restricted Premier shares using the bid price for unrestricted Premier shares as a floor, and that the independent directors approved the information Respondent Calandrella provided about the Fund's portfolio without any exploration of fair market value. Finally, there is no reason to doubt the [SEC] examiner who recalled that Respondent Calandrella told him in March 1994 that he prepared the valuations and the board signed off on them with very little discussion."

In light of these findings, the SEC administrative law judge issued cease and desist orders to Calandrella and the independent directors of the fund, permanently barred Calandrella from any affiliation with an investment company or investment adviser, barred the independent directors from any affiliation with an investment company or investment adviser for three years, assessed Calandrella a civil penalty of $500,000, and assessed each of the independent directors a civil penalty of $160,000 ($20,000 for each incorrect filing made with the SEC). Although this was obviously an egregious set of facts, the financial press and the investment company industry have perceived this case as evidence that the SEC intends to take a much harder line on issues of valuation in the future.

3. Receivership – Heartland

On March 21, 2001, the SEC obtained a consent decree against Heartland Group, Inc., freezing the assets of the four Heartland municipal bond funds, suspending redemptions in the funds, and appointing a receiver to manage and, if necessary, liquidate the funds. This followed the failure of the funds to file their annual reports with the SEC, because of their inability to obtain audited financial statements; the independent auditors were unwilling to issue an opinion as to the value of the funds' portfolio securities during the funds' 2000 fiscal year.

This SEC action followed the reduction of the net asset value of the Heartland High-Yield Municipal Bond Fund by 70% and of the Heartland High-Yield Short Duration Municipal Fund by 44% on October 13, 2000. The reduction in value was because of a change in valuation methodology for the funds' portfolio of thinly traded municipal bonds, which the board concluded were being inappropriately priced by the fund's pricing service at values far above what would likely be received upon sale of the bonds. As a result of this action, a number of lawsuits have been filed against the funds, the investment adviser, the directors, the portfolio manager at the time of the reduction and his predecessor (who resigned several weeks before the reduction took place) and the independent auditors.

III. Valuation Procedures and Practices

Q. *Can the directors of a mutual fund delegate some or all of their "fair value" responsibilities to others?*

A. *The SEC's responses are, somehow, reminiscent of the "Mad Tea Party" of Alice in Wonderland:*

> *There was a table set out under a tree in front of the house, and the March Hare and the Hatter were having tea at it: a Dormouse was sitting between them, fast asleep, and the other two were using it as a cushion, resting their elbows on it, and talking over its head. "Very uncomfortable for the Dormouse," thought Alice; "only, as it's asleep, I suppose it doesn't mind."*
>
> *The table was a large one, but the three were all crowded together at one corner of it: "No room! No room!" they cried out when they saw Alice coming. "There's* ***PLENTY*** *of room!" said Alice indignantly, and she sat down in a large arm-chair at one end of the table.*
>
> *"Have some wine," the March Hare said in an encouraging tone.*
>
> *Alice looked all round the table, but there was nothing on it but tea. "I don't see any wine," she remarked.*
>
> *"There isn't any," said the March Hare.*
>
> *"Then it wasn't very civil of you to offer it," said Alice angrily.*

"It wasn't very civil of you to sit down without being invited," said the March Hare.

"I didn't know it was YOUR table," said Alice; "it's laid for a great many more than three."

"Your hair wants cutting," said the Hatter. He had been looking at Alice for some time with great curiosity, and this was his first speech.

"You should learn not to make personal remarks," Alice said with some severity; "it's very rude."

The Hatter opened his eyes very wide on hearing this; but all he SAID was, "Why was a raven like a writing-desk?"

"Come, we shall have some fun now!" thought Alice. "I'm glad they've begun asking riddles.—I believe I can guess that," she added aloud.

"Do you mean that you think you can find out the answer to it?" said the March Hare.

"Exactly so," said Alice.

"Then you should say what you mean," the March Hare went on.

"I do," Alice hastily replied; "at least—at least I mean what I say—that's the same thing, you know."

"Not the same thing a bit!" said the Hatter. "You might just as well say that 'I see what I eat' is the same thing as 'I eat what I see'!"

"You might just as well say," added the March Hare, "that 'I like what I get' is the same thing as 'I get what I like'!"

"You might just as well say," added the Dormouse, who seemed to be talking in his sleep, 'that I breathe when I sleep' is the same thing as 'I sleep when I breathe'!"

"It IS the same thing with you," said the Hatter, and here the conversation dropped, and the party sat silent for a minute, while Alice thought over all she could remember about ravens and writing-desks, which wasn't much.

As noted above, the 1940 Act provides that the board of directors is responsible for determining the fair value of securities that do not have readily available market quotations. This is one of only four duties for directors mandated by the 1940 Act.[39] Unlike each of the other three statutorily required actions, however, the 1940 Act does not provide any guidance on how a board of directors should fulfill its fair value pricing responsibilities. Generally, in such cases, one looks to state law for guidance. Indeed, as the U.S. Supreme Court has recognized, the 1940 Act does not displace state laws governing the powers of directors (unless such state laws would permit action prohibited by the 1940 Act or unless their application would be inconsistent with identifiable federal policy).[40] In particular, the Court confirmed that state law, and not the 1940 Act, is the source of authority for managerial power.

Under many state corporation statutes, a board of directors may delegate to a committee of the board many of the powers of the board. In certain circumstances, a board of directors may also delegate certain powers of the board to non-board members.

Notwithstanding the broad powers of delegation permitted by state law, the SEC and its staff have expressed their views over the years on how a board of directors should fulfill fair value pricing responsibilities. As noted above, the SEC's accounting series releases (ASR 113 and ASR 118) seem to contemplate a more active role for fund boards in the day-to-day valuation determinations (e.g., the requirement to determine the method of arriving at the fair value of "each" security and the requirement to "continuously review" the appropriateness of the method used involving each security).[41] Moreover, in enforcement actions, the SEC has emphasized that directors "may not delegate to others the ultimate responsibility" for fair valuation.[42]

In practice, many boards delegate day-to-day valuation activities to a committee of the board or the adviser. This practice is supported by, for example, the SEC statements in ASR 118, that "the board may appoint persons to assist them in the determination of [fair] value, and to make the actual calculations pursuant to the board's direction." In 1973, the SEC staff granted no-action relief that allowed the board of directors of a closed-end fund to delegate its fair valuation responsibilities to a valuation committee consisting of both management and board representatives.[43] This no-action position, while helpful, has also raised questions: Does it apply to open-end funds? Can the valuation committee consist solely of management representatives?

In 1999, the SEC staff had an opportunity to provide guidance as to how (and how much) directors can delegate their fair value responsibilities to non-directors. In a somewhat elliptical way, the staff said:

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[39] The only four duties for directors mandated by the 1940 Act are: (i) determination of fair value (Section 2(a)(41)); (ii) approval of the investment advisory agreement (Section 15); (iii) approval of the distribution agreement (Section 15); and (iv) selection of auditors (Section 32(a)).

[40] *Burks v. Lasker*, 441 U.S. 471 (1979).

[41] ASR 118.

[42] *Seaboard Associates*, *see* footnote 28.

[43] Paul Revere Investors Inc. (pub. avail. March 23, 1973).

"Some commentators have suggested that, in light of the changes in securities and markets, mutual fund boards are ill-equipped to fair value price portfolio securities and that the obligations placed on boards by the 1940 Act are unworkable. Mutual fund boards, however, typically are only indirectly involved in the day-to-day pricing of a fund's portfolio securities. 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. In reviewing and approving pricing procedures, boards should determine whether those methodologies and procedures are reasonably likely to result in the valuation of securities at prices which the funds could expect to receive upon their current sale. Mutual funds also may use a number of other techniques to minimize the burdens of fair value pricing on their directors. For example, a number of funds delegate certain responsibilities for fair value pricing decisions to a valuation committee. Such committees generally assist the board in developing methodologies by which fair values are to be calculated, and implement the board-approved methodologies on a day-to-day basis or as frequently as necessary.

A mutual fund board can take significant steps toward satisfying its good faith obligations prior to an emergency or unusual situation. We believe that, in general, the degree of involvement required of a board 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. If, for example, a board has approved comprehensive procedures which provide methodologies for how fund management should fair value price portfolio securities, including procedures which would be appropriate for that particular emergency situation, a board would need to have comparatively little involvement in the valuation process in order to satisfy its good faith obligation. This necessitates, of course, that the board periodically review the appropriateness of the methods used to fair value price portfolio securities and the quality of the prices obtained through these procedures, and that it make changes when appropriate."

This author believes that additional clarity on the ability of directors to delegate their fair value responsibilities is warranted and suggests that the SEC consider issuing interpretive guidance or promulgating a rule that expressly permits fund directors to delegate to the investment adviser and/or others the responsibility to make fair value determinations required of the board of directors under Section 2(a)(41) of the 1940 Act, provided:

- *the fund's board of directors, including a majority of the directors who are not interested persons of the fund ("independent directors"): (i) establishes and periodically reviews written guidelines and procedures under which the delegate makes such determinations and (ii) approves such changes to the guidelines and procedures as the board deems reasonably necessary;*

- *the board takes measures reasonably necessary to determine that the guidelines and procedures have been followed;*

- *the board reviews at least quarterly a written report on all fair value determinations made during the preceding quarter; and*

- *the fund: (i) maintains and preserves permanently in an easily accessible place a written copy of the guidelines and procedures and (ii) maintains and preserves for a period of not less than six years from the end of the fiscal year in which any determination occurred, the first two years in an easily accessible place, a written record of each such determination setting forth a description of the security, the fair value determination made with respect to that security, and the identity of the person(s) involved in making the determination.*

IV. The Role of Auditors

As a part of the review of the valuation process, directors should: (i) understand the procedures that the auditors use to verify prices and (ii) receive the auditors' assessment of the internal controls over the pricing process.

Under generally accepted auditing standards, a mutual fund's independent auditors should verify the prices of the fund's portfolio securities as part of the fund's annual audit and assess the fund's internal controls over the valuation process. The SEC has also suggested that the auditors should verify independently the prices for all the fund's portfolio securities as of the balance sheet date. Although not necessarily embraced by the accounting profession, another SEC staff suggestion is that, even in the case of "only one market maker or broker-dealer providing a market quotation, the independent accountant should employ alternative procedures that provide an accurate and reasonable valuation."[44]

V. Pricing Errors

The SEC's historical position on the materiality of fund pricing errors has been that a pricing error should be considered material if the error in itself affects fund per share NAV by 1¢

[44] Letter to Chief Financial Officers from Lawrence A. Friend, Chief Accountant, SEC Division of Investment Management (November 1, 1994).

or more.[45] In *Securities and Exchange Commission v. Charles W. Steadman, et al.*,[46] however, the court rejected the SEC's position that "A penny per share is *per se* material . . ."

In light of the *Steadman* decision, certain SEC staff members have informally articulated an alternative standard for determining when, and what type of, financial adjustments should be made for pricing errors. Specifically, staff members have indicated that pricing errors of less than 1¢ per share would be considered immaterial and thus would not require retroactive corrective action. These staff members further indicated that errors of 1¢ or more would require financial adjustments in favor of the fund and that errors in an amount equal to ½ of 1% or more of the fund's NAV also would require payments to affected individual shareholders and reprocessing of shareholder accounts. The staff has also generally acquiesced in a *de minimis* threshold (e.g., $10 or $25) per shareholder account before compensation must be paid to individual investors.

As a result of the *Steadman* case and informal discussions with the SEC staff, many fund complexes have developed a two-part process for NAV errors. This standard examines the effect of the error at the fund level and at the shareholder level. If there is an NAV error equal to or greater than 1¢, but less than ½ of 1% of the NAV, the error would be considered material only at the fund level. Shareholder accounts would not need to be reprocessed. However, the fund would be "made whole" by the party responsible. If the NAV error is greater than ½ of 1% of NAV, the error would be considered material at the shareholder level. In that case, accounts that were adversely affected (above a *de minimis* amount of $10 or $25) would be reprocessed. Appendix B illustrates this error correction policy.

VI. Conclusion

In recent years, the SEC has significantly "upped the ante" for fund directors in the valuation game. In the past, the SEC sanctioned advisers, not fund directors, for fair valuation transgressions. Now, fund directors are in the line of fire. Although valuation has always been important, it is even more critical today for fund directors to bring appropriate oversight and deliberation to the fair valuation process. To fulfill their responsibilities, directors should adopt detailed written valuation policies and procedures, monitor the implementation of those policies and procedures and review and modify those policies and procedures as necessary. Finally, directors should carefully document their fair value decision making process.

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[45] *See* Rule 2a-4(b), which provides that certain expense and income items that normally must be included in fund NAV calculations need not be included if the effect of doing so would "not amount to as much as 1 cent per share." This materiality standard refers to pricing errors that equal at least a full 1¢ per share, rather than those that would be rounded to 1 cent or that, when added to the prior NAV, would result in a change of 1 cent or more. *See also* Accounting Series Release No. 219 (May 31, 1977), which, in discussing use of the amortized cost method of valuation, stated that "[g]enerally, the Commission would consider the use of a particular valuation method to have a material impact if the use of that method, as opposed to another method, might cause a change of at least one cent in a net asset value per share of $10.00" and that "[a]lthough one cent differences in net asset values per share of $10.00 might appear to be insignificant, the effects of such differences can be material to the decisions of investors when translated into differences in rates of return."

[46] *Securities and Exchange Commission v. Charles W. Steadman, et al.*, 967 F.2d 636 (D.C. Cir. 1992).

APPENDIX A

Questions That Directors Should Ask about Valuation

General

- Has the fund adopted written valuation policies and procedures identifying all pricing sources and valuation methodologies by type of security?
- How does the board document its review of fair value decisions and/or methodologies?
- How are the prices produced by the fund's fair valuation methodologies tested (including prices provided by pricing services)?

Pricing Services

- Which pricing services are used for which securities and why?
- Do the pricing services provide "bid" or "mean" valuations?
- How do the pricing services formulate their valuations (e.g., market quotes, matrix pricing)?
- What due diligence did the adviser perform on the pricing services?
- Does the adviser use a secondary pricing service on a periodic basis (e.g., weekly) to test the valuations being received? Does the Board receive a periodic report reflecting the results of such testing?
- Can the adviser "override" prices? If so, why?

  Does the portfolio manager participate in the override decision?
  Who else participates in the override decision?
  How are overrides documented?
  How frequently do overrides occur?
  What is the frequency of price overrides?
  Do most overrides result in increased or decreased valuations?

- How do actual sales prices (from disposition of portfolio securities) compare to the most recent price provided by the pricing service? Does the Board receive a periodic report reflecting the results of such comparisons?

Direct Dealer Quotes

- What is the adviser's understanding with dealers that agree to provide such quotes (e.g., is the quote a price for an immediate transaction or is it based upon the dealer's assessment of a transaction price between willing buyers and sellers given a reasonable period of time to "work" the order)?

- What is the adviser's process of verifying the validity of the quote (e.g., does the adviser periodically "hit the bid")?

Valuation Committee

- Does the Board use a valuation committee or other protocol to react quickly to fair valuation events and situations?

- What are the valuation committee's procedures for calling a meeting, consulting the portfolio manager and others, and consulting other industry sources (e.g., ICI, custodian, counsel, etc.)?

- How frequently does the valuation committee review individual fair values or fair valuation methods?

- What ongoing monitoring of market and other events does the valuation committee use to determine the continued validity of the price?

- How does the fair value price approved by the valuation committee compare to the next available market quotation or sale?

APPENDIX B

NAV ERROR CORRECTION