Fair Valuation Series

An Introduction to Fair Valuation

INVESTMENT COMPANY INSTITUTE®
INDEPENDENT DIRECTORS COUNCIL™

ICI MUTUAL INSURANCE COMPANY®

Fair Valuation Series

An Introduction to Fair Valuation	Spring, 2005
The Role of the Board	Forthcoming
Fair Valuation in Practice	Forthcoming
Pricing Errors and NAV Corrections	Forthcoming

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Introduction

Mutual funds are in the business of investing in securities, and the value they place on those securities has a direct impact on their shareholders. Every business day, a fund must determine the value of each portfolio security it holds to calculate its net asset value per share (NAV). The fund's NAV then is used to process purchases, redemptions, and exchanges by shareholders.

The Investment Company Act sets forth the legal framework for valuation: securities for which market quotations are "readily available" must be valued at market value, and all other securities and other assets must be valued at "fair value" as determined in good faith by the fund's board of directors or trustees. Although the legal framework is simple, the valuation process has many subjective elements and can be complex.

The Investment Company Institute, ICI Mutual Insurance Company, and the Independent Directors Council are publishing the ***Fair Valuation Series*** to assist funds (other than money market funds) and their boards in addressing securities valuation. This installment of the Series provides an overview of issues to consider in developing and administering valuation policies and procedures. Subsequent installments will explore specific valuation topics in detail, such as the valuation of particular types of securities, the role of a fund's board of directors in the fair valuation process, and the correction of pricing errors.

The ***Fair Valuation Series*** is not a set of best practices. Each fund's approach to the valuation of securities will depend on many factors particular to that fund. Ultimately, each fund's board and management, acting in good faith and exercising their reasonable business judgment, will have to consider a broad array of factors to devise an appropriate approach to fund valuation.

Key Developments on Fair Valuation

1940
The Investment Company Act of 1940 is enacted, requiring fund boards to determine fair value prices in good faith when market quotations are not readily available.

1969
The SEC issues Accounting Series Release 113 providing guidance on valuing restricted securities.

1970
The SEC issues Accounting Series Release 118 providing general guidance on fair valuation and the board's related responsibilities.

1981
The SEC staff issues a "no action" letter to Putnam funds stating that funds may use closing market prices for foreign securities "except when an event has occurred … that is likely to have resulted in a change in [their] value."

1984
The SEC affirms the staff position in the Putnam letter in a release proposing amendments to Rule 22c-1.

1997
ICI publishes a white paper on valuation and liquidity issues for mutual funds.

In response to extreme volatility in U.S. and Asian markets, a few funds fair value price Asian securities. Some investors challenge this action, and the SEC initiates a review of fair value pricing.

1998

Following its 1997 review of fair value practices, the SEC takes steps to enhance fair value disclosure in fund prospectuses. In the release, the SEC states that in response to the 1997 market volatility, "funds appear to have relied on a long-standing position of the Commission's staff that a fund may (but is not required to) value portfolio securities traded on a foreign exchange using fair value . . . when an event occurs after the close of the exchange that is likely to have changed the value of the securities."

1999

The SEC staff issues a letter to ICI providing guidance on valuation responsibilities during unusual or emergency situations.

2001

The SEC staff issues a second letter to ICI explaining the concept of "significant events" in the context of fair valuing foreign securities. The letter states that market fluctuations may constitute significant events.

2002

ICI publishes a supplement to its valuation and liquidity white paper. The supplement focuses on "significant events" and the valuation of foreign securities.

2003

The SEC release adopting Rule 38a-1 outlines four obligations relating to fair valuation.

2004

The SEC amends its disclosure rules to require disclosure of the circumstances under which funds will use fair value pricing and the effects of using fair value pricing. The SEC states in the adopting release that "funds are required to use fair value prices any time that market quotations for their portfolio securities are not … reliable."

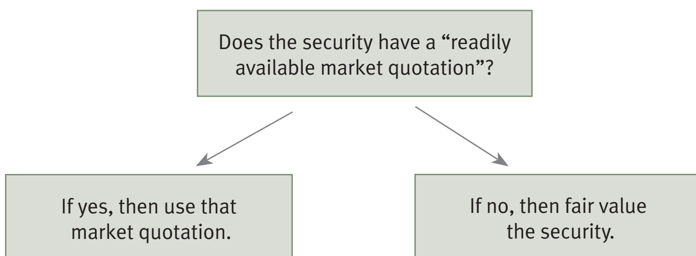
What Are a Fund's Valuation Obligations?

Statutory Framework

The definition of "value" in the Investment Company Act has two elements: securities for which market quotations are "readily available" are to be valued at market value, and all other securities and other assets are to be valued at "**FAIR VALUE**" as determined in good faith by the fund's board of directors. This sets up a simple decision tree for valuation:

TERMINOLOGY: FAIR VALUE

*The **"fair value"** of a security is the price that the fund might reasonably expect to receive upon a current sale.*



The SEC has provided guidance over the years on the meaning of "readily available market quotation" and "fair value." As discussed below, this guidance addresses when a market price for a security should be disregarded because it is unreliable or otherwise not "readily available."

Valuation Obligations

The SEC has outlined four obligations relating to fair valuation. When it adopted the compliance program rule (Rule 38a-1 under the Investment Company Act), the SEC stated that a fund must:

1. Adopt written policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value pricing;
2. Establish criteria for determining when market quotations are not reliable for a particular security;
3. Establish a methodology or methodologies to determine the current fair value of a security; and
4. Regularly review the appropriateness and accuracy of the methods used in valuing securities.

This installment of the *Fair Valuation Series* focuses on issues funds may wish to consider in fulfilling these obligations and developing fair valuation disclosure.

"There is no uniform method or single standard for fair value pricing because it necessarily requires some measure of judgment and flexibility."

Paul F. Roye, Director of the SEC's Division of Investment Management
February 25, 2004

Establishing Valuation Policies and Procedures: What Are the Key Issues to Consider?

Valuation policies generally serve to: 1) define the roles of various parties involved in the valuation process; 2) describe the ways that the fund will monitor for situations that might require fair valuation; 3) describe valuation methodologies that a fund's board has approved for particular types of securities; and 4) describe the methods by which the fund will review and test fair valuations to evaluate whether its valuation procedures are working as intended.

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A subsequent installment in the **Fair Valuation Series** *will discuss in more detail the role of the board in the valuation process.*

Defining Roles and Responsibilities

In defining the roles of the parties involved, funds should consider the role of the board, the role and composition of valuation committees, the role of others in the valuation process, and the need for escalation procedures. Each of these is discussed below.

The Role of the Board

Directors' involvement in the fair valuation process typically consists of approving fund valuation policies and procedures, monitoring their implementation, and periodically reviewing the fair valuation decisions and changes to valuation policies made by pricing personnel or valuation committees. Typically, the board and individual board members are not involved in day-to-day valuation decisions.

Key Point

The Investment Company Act places ultimate responsibility for fair valuation on fund boards. SEC and staff guidance enables boards to delegate day-to-day fair value decisions.

The Role and Composition of Valuation Committees

Most funds have valuation committees, but practices vary widely as to their precise role and composition and the frequency with which they meet, often reflecting the nature of valuation issues faced by a fund. If a fund invests significantly in securities that may be difficult to value, it may have more experienced or senior committee members, and the committee may meet more frequently. On the other hand, if a fund invests exclusively in actively traded domestic securities, it may have no need for a valuation committee or may have one that meets infrequently.

If a fund uses a valuation committee, it should define the committee's membership, scope of delegated authority, and reporting obligations to the board. This often is done either in a written charter or in the fund's valuation policies and procedures.

There are special considerations in having board members or lawyers serve on a valuation committee:

Key Point

Board members and lawyers have special considerations in deciding whether to serve on valuation committees.

- *Board members.* Independent directors of some funds serve as members of valuation committees. While this may enhance board oversight of the valuation process, it also may require a substantial commitment of a director's time. Directors may wish to consider the differences in the role they would assume by virtue of being an active participant in valuation committee decisions, on the one hand, and a reviewer of those decisions, on the other.
- *Lawyers.* General counsel or other attorneys of the fund's adviser often serve on valuation committees because of their knowledge of fund valuation obligations. Attorneys, however, may wish to consider attending valuation committee meetings in their capacity as counsel to the committee, rather than as a member of the committee per se. This approach may help maintain the counsel's objectivity in case a review of the committee's activities or the fund's valuation practices is necessary. It also may enable the fund to assert the attorney-client privilege for communications with counsel arising from the committee's activities.

Others Involved in the Valuation Process

The valuation process often involves these personnel:

- *Accounting personnel.* Accounting personnel typically have day-to-day pricing responsibility, including monitoring for events that might require the use of fair value prices. Funds that have established valuation committees often ask senior accounting personnel, including the Treasurer or Chief Financial Officer, to serve on those committees.

- *Investment professionals.* Investment professionals, such as portfolio managers and analysts, often are included in the valuation process because they are important sources of information about the value of securities. At the same time, investment professionals may have potential conflicts of interest if the valuations used by the fund affect a fund's performance and their own compensation.

  The extent of the conflicts that might arise varies from fund to fund depending on the precise role the investment professionals are expected to play in the valuation process and their compensation structure. When investment professionals are used in the valuation process, funds should take steps to enhance their valuation procedures to minimize any potential conflicts of interest. For example, funds may require a senior member of management to sign off on valuation decisions made by investment professionals.

- *Chief Compliance Officers (CCOs) and other compliance personnel.* CCOs and other compliance personnel have an important role in ensuring that a fund's valuation procedures are reasonably designed to prevent the fund from violating the federal securities laws and are being followed.

Key Point

Investment professionals can be important sources of information about the value of securities, but funds should recognize that there may be potential conflicts of interest that should be addressed.

Escalation Procedures

A fund's procedures should include a process for addressing any difficulties or problems that may arise in the valuation process, including clear instructions on the timely escalation of valuation issues. That clarity can help every person involved understand when a valuation matter needs to be escalated to someone higher in the organization, and to whose attention it should be brought, including that of the fund's board.

Monitoring for Circumstances that May Require Fair Value Pricing

The SEC requires funds "to monitor for circumstances that may necessitate the use of fair value prices." This means monitoring for circumstances in which market quotations for portfolio securities may not be readily available. Whether a particular market quotation is or is not "readily available" is highly fact-specific.

The SEC staff has described various events that ordinarily would cause a fund to consider fair valuing a portfolio security. Broadly summarized, these are events that occur after the last market price was established but before the time set for the calculation of the fund's NAV, and that suggest that the market price no longer represents the security's value. There are two concepts here: 1) the lack of a current market quotation and 2) the occurrence of a "significant event."

The Lack of a Current Market Quotation

Funds may wish to monitor for the following types of circumstances where there may not be a current market quotation:

- *Markets closing before 4:00 pm Eastern time.* Many foreign markets are closed at 4:00 pm Eastern time when most funds cut off orders and begin to calculate their NAVs. As a result, market quotations for securities principally traded on these exchanges may no longer be current at that time.
- *Trading halts.* The last market quotation for a security that was subject to a trading halt may not be current, if the halt remains in place at the end of the trading day.
- *Events that unexpectedly close entire markets.* Natural disasters, power blackouts, public disturbances, or similar major events could force a market to close unexpectedly.
- *Scheduled market holidays.* A scheduled holiday in a market (other than the NYSE) could call into question whether securities that principally trade on that market have current market quotations.
- *The absence of trading.* The absence of trading in an individual security could raise the issue of whether that security has a current market quotation. This may be a common occurrence with respect to some small capitalization stocks and many fixed income securities.

Example

Closing prices for securities trading on the Tokyo Stock Exchange, for example, are established either 14 or 15 hours before 4 pm Eastern time, depending on Daylight Savings Time.

Terminology: Significant Event

*The term **"significant event"** is defined as an event that will affect the value of a fund's securities that has occurred after closing prices were established for those securities, but before the specific time set for the fund's NAV calculation. The term was defined in the SEC staff's April 2001 letter to ICI on valuation issues.*

Terminology: Market-Based Proxies

*In this context, the term **"market-based proxies"** refers to securities, baskets of securities (such as ETFs), or market indexes that might be actively trading when the individual security being valued by the fund is not.*

Significant Events

If a security lacks a current market quotation, funds should have procedures to monitor whether some "**SIGNIFICANT EVENT**" happened that suggests that the value of the security has changed. Significant events could be: 1) events relating to a single issuer, such as an after-hours earning announcement; 2) events relating to an entire market sector, such as a significant governmental action like raising interest rates; 3) natural disasters that affect securities values, such as an earthquake; or 4) a significant fluctuation in domestic or foreign markets.

Market fluctuations as "significant events." The SEC staff, in a 2001 interpretive letter to ICI, stated that a significant fluctuation in domestic or foreign markets may constitute a significant event. This concept appears to be based on a finding of historical correlations between market movements and the subsequent prices of particular securities.

Since the SEC staff issued its letter in 2001, pricing methodologies have been developed that allow funds to take market movements into account in the fair valuation process. Many of these methodologies are based on changes in the value of "**MARKET-BASED PROXIES**" such as:

- The U.S. market, to the extent that the U.S. market may bear a correlation to the particular foreign market;
- Baskets of American Depository Receipts (ADRs) relating to securities in the foreign market;
- Futures contracts or other derivative securities based on indexes representative of the foreign market; and/or
- Baskets of securities from the foreign market or funds that are comprised of those securities, such as exchange-traded funds (ETFs) or closed-end country funds.

Funds may find market-based proxies useful singularly or in combination with each other.

Example: The Use Of Market-Based Proxies

Assume a fund owns Japan Manufacturing Corporation, Ltd. (JMC), a stock listed on the Tokyo Stock Exchange (TSE) that tends to trade in line with the Nikkei 225 Index. At 1:00 am Eastern time Monday, JMC closes on the TSE at $10 a share. By 4:00 pm Eastern time (the time the fund values its portfolio securities), futures on the Nikkei 225 Index that trade on the Chicago Mercantile Exchange are up 10%.

The facts that JMC tends to trade in line with the Nikkei 225 Index and that Nikkei futures trading in the U.S. are up 10%, taken together, suggest that the current value of JMC might have increased to $11 as of 4:00 pm Eastern time. In other words, there is an indication that a reasonable buyer and reasonable seller of JMC at 4:00 pm might conduct their transaction at $11, rather than the $10 closing price on the TSE established earlier in the day.

In the absence of actual trading in the security, trading in the Nikkei futures in this example could provide a reasonable “market-based proxy” of what might be expected from trading in the Japanese equity security being valued.

Monitoring correlations. Identifying correlations between portfolio securities and various market-based proxies—and conducting fair valuation thereon—can be very complex. As a result of the number of securities potentially involved and the narrow time window in which funds must value their portfolios daily, many funds have found it necessary to consult third-party vendors that offer pricing products and services based on such correlations, particularly with respect to foreign equities. These vendors use extensive historical data to perform correlation studies that make it possible for funds to determine fair values based on the movement of market-based proxies.

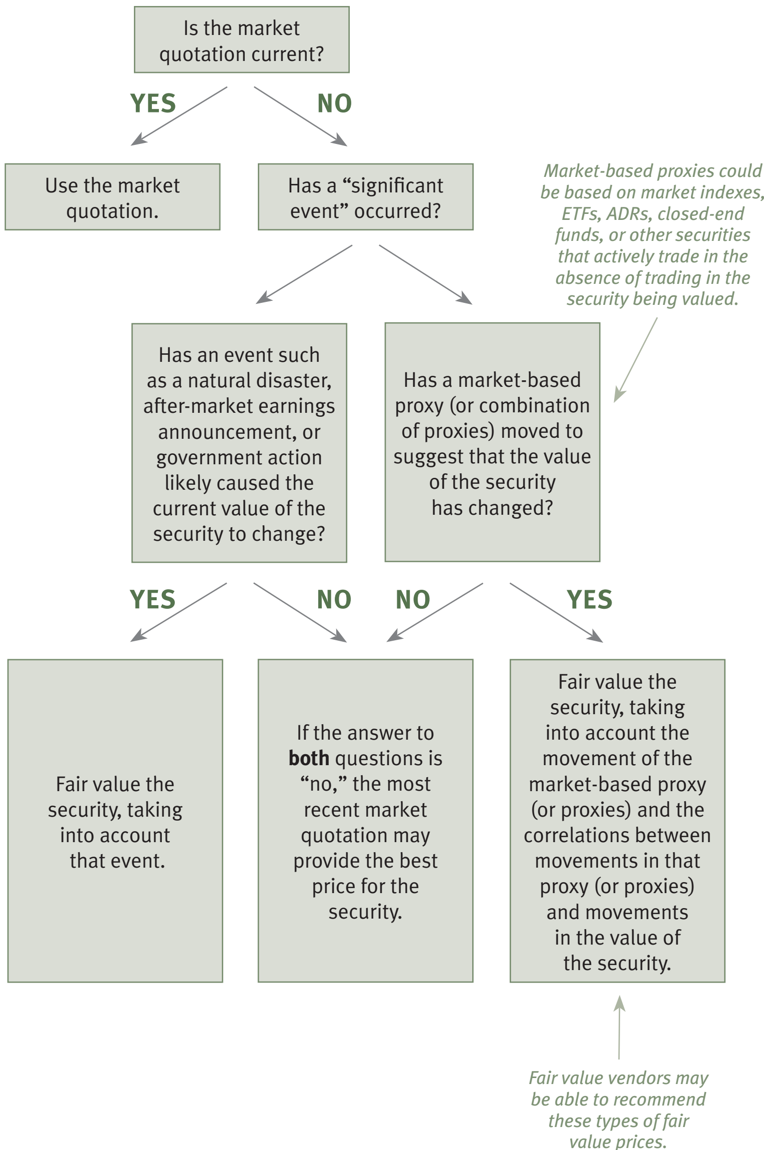
Terminology: Trigger

A movement in some index or security above a certain stated amount. For example, funds could set a 75 basis-point trigger pegged to movements in the S&P 500 Index. This would mean that the fund would use the information provided by a vendor only if the S&P 500 Index closed more than 0.75 percent up or down from its previous close.

A fund that uses a pricing vendor in the fair valuation process must consider when and how it will use the information provided by the vendor. Some funds establish a threshold "**Trigger**." These funds may take into account the vendor's data only on days when the trigger has been exceeded. On other days, these funds may conclude that closing market prices reflect the security's current value. Other funds may conclude that it is reasonable to use the vendor's data more frequently – or even every day, a "no trigger" or "zero trigger" approach.

Each fund should determine the appropriate level and benchmark for any trigger based on its own due diligence and understanding of the correlations relevant to its portfolio.

Questions to Ask in Deciding Whether to Use a Market Quotation



Trend

Funds are developing detailed valuation procedures for specific types of securities.

Outlining Specific Valuation Techniques and Methodologies

Increasingly, fund valuation procedures describe specific valuation techniques and methodologies that will be used by the fund, including methodologies for particular types of securities. The SEC staff has stated that if a fund board has approved comprehensive fair valuation policies that provide methodologies for how fund management should fair value securities, a board can have comparatively little involvement in the day-to-day valuation process. A fund also may be able to automate certain fair valuation processes involving techniques based on objective criteria (e.g., quantitative models to fair value foreign equity securities) if fund procedures clearly identify the techniques, describe how and when they will be used, and provide a process for periodic board review of the resulting valuations.

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Common valuation techniques used for various types of securities will be discussed in more detail in a subsequent installment in the **Fair Valuation Series**.

When drafting valuation procedures, funds may find it useful to start by considering the types of securities that they typically will hold. Funds may also take into account their investment approach in crafting valuation procedures. A fixed income fund that invests primarily in fixed income securities using a quantitatively oriented investment approach might describe, in specific quantitative terms, the formulas used for fair value in certain situations. An equity fund managed primarily using fundamental research, on the other hand, might use procedures that consider fundamental factors and input from analysts.

Reviewing and Testing Valuations

Why Back-Test?

The SEC requires funds to review regularly the appropriateness and accuracy of the methods used in fair valuing securities. Back-testing fair valuations can assist funds in fulfilling this requirement.

The purpose of back-testing is to identify any significant bias in the fair value procedures and evaluate the reasonableness of using data provided by vendors. In other words, the testing permits the fund to assess the operation of particular valuation methodologies in specific situations and over time, so that those methodologies can be adjusted going forward as needed in light of changing conditions or experience. It is important to understand that the primary goal of testing is not to assess the accuracy of the valuation. By definition, fair value prices are good faith estimates of a security's value. For this reason, funds have, consistent with SEC guidance, focused their attention on developing appropriate processes for making informed valuation decisions and on following those processes consistently and in good faith.

Key Point

*Funds should focus on developing appropriate **processes** for making informed valuation decisions and on following those processes consistently and in good faith.*

How To Back-Test

Fair valuations can be back-tested in a variety of ways. Two common methods are comparing actual trades against fair values and comparing fair values against the next available market price.

- *Testing actual trades.* This procedure compares the prices used in any actual trades of a security against the fair value that the fund used for that security. If the actual trade occurred at a price that is significantly different than the fair value price, the trade typically is brought to the attention of valuation personnel or the valuation committee. If this occurs in a meaningful number of instances, the fund may wish to consider reviewing and modifying the procedures by which fair value prices are set.

- *Testing fair values against subsequent market prices.* This procedure compares fair values against the last market prices and next available market prices, such as the next-day opening price for foreign securities. This type of test can show whether the fair values used by a fund were generally closer to the subsequent market prices, both in terms of the direction and magnitude of the change from the previous market price. Funds that use this type of procedure should recognize that in most cases a security's next market price will not represent its earlier fair value. Nevertheless, that market price may be the most contemporaneous price available, and as such may provide some help as a fund reviews the appropriateness and accuracy of its valuation methodologies.

Back-Testing by Vendors

Funds that use an external pricing vendor in the fair valuation process should consider the extent of the vendor's own back-testing in determining how the fund should test its valuation methodologies. As part of its due diligence prior to the engagement of a particular vendor, the fund should take steps to understand the nature and frequency of the back-testing that the vendor will perform and the modifications that the vendor may make as a result of that testing. In addition, the fund may wish to consider periodically performing its own back-testing.

The Role of Fund Auditors

Auditors seek to independently verify values for the fund's portfolio securities. This is not possible for fair valued securities, where there are no observable market prices that would enable independent verification. Instead, for fair valued securities, auditors consider whether the fund's valuation method was appropriate in the circumstances and applied consistently. As a result, auditors do not substantively verify fair value prices: they do not make an independent determination as to what the fair value of a security should have been or whether the fund, if it sold a security, would realize the price at which a security is being valued.

The frequency with which a fund uses fair valuation should not impact the fund's ability to get an unqualified audit opinion on the fund's financial statements, as long as the fund's valuation procedures were appropriate in the circumstances and applied consistently.

> "Fair valuation procedures must continuously be back-tested, critiqued, and refined in order to maximize their effectiveness for the benefit of shareholders. Fair valuation, therefore, must be a dynamic process."
>
> *Paul F. Roye, Director of the SEC's Division of Investment Management*
> *April 2, 2004*

Disclosure: How Are Valuation Policies and Procedures Disclosed?

The SEC requires funds to explain in their prospectuses both the circumstances under which they will use fair value pricing and the effects of using fair value pricing. SEC instructions state that the disclosure should be brief, and that funds are not required to provide detailed information about their fair value pricing methodologies and formulas.

In practice, striking an appropriate balance with respect to disclosure can be challenging. Overly specific disclosure could provide abusive traders with information that they could use to harm a fund. On the other hand, inadequate or incomplete disclosure could subject the fund to SEC enforcement action or private litigation.

Other Valuation Resources: Where Can I Find More Information?

Regulatory Framework:

- Investment Company Act
  Sections 2(a)(41), 22(c), and 22(e)
- Investment Company Act
  Rules 2a-4, 22c-1, and 38a-1

  Available through links at the SEC's Division of Investment Management website at www.sec.gov/divisions/investment.shtml.

Industry Guidance:

- ICI's white papers: *"Valuation and Liquidity Issues for Mutual Funds"* (February 1997 and March 2002)

  Available to ICI members on members.ici.org.

Notable SEC Enforcement Actions:

- Parnassus Investments (September 3, 1998)
- Piper Capital Management (August 6, 2003)
- The Heartland Funds:
  - FT Interactive Data (December 11, 2003)
  - Jon D. Hammes, et al. (December 11, 2003)
- Van Wagoner Capital Management (August 26, 2004)

SEC Guidance:

- April 30, 2001 and December 8, 1999 SEC staff letters to ICI
- ASR 113 (October 21, 1969) and ASR 118 (December 23, 1970)

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