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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

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December 8, 1999

Mr. Craig S. Tyle
General Counsel
Investment Company Institute
1401 H Street, N.W.
Washington, D.C. 20005

Dear Mr. Tyle:

As a result of recent events, we believe that it would be helpful to some open-end management investment companies ("mutual funds" or "funds") to review their obligations to price and redeem fund shares during emergency or unusual situations. As you know, the ability to redeem fund shares is a primary consideration for mutual fund investors, especially during emergency or unusual situations. Because all funds may experience emergency or unusual situations at some point, we believe that it would be useful to review funds' pricing obligations under the law, and to provide additional guidance to funds on their obligations to price and redeem their securities during these and other situations.

We discuss below three issues relating to funds' responsibilities for pricing portfolio securities. First, we clarify that market quotations for portfolio securities are not readily available when the exchanges or markets on which those securities trade do not open for trading for the entire day, and that funds, accordingly, must price those securities based on their fair value ("fair value price"). Second, we provide additional guidance regarding the process of fair value pricing, and describe certain factors that funds should consider when fair value pricing portfolio securities. Finally, we discuss the obligations of fund boards of directors ("boards") for fair value pricing securities, and discuss measures that boards may take when discharging those responsibilities.

<u>Section 22(e) and Rule 22c-1</u>

The Investment Company Act of 1940 ("1940 Act") requires mutual funds to price and redeem their shares at the net asset values ("NAV") next computed after receipt of redemption requests, and to make prompt payment of redemption proceeds.[1]

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[1] Section 22(e) of the 1940 Act generally prohibits mutual funds from suspending the right of redemption and prohibits funds from postponing the payment of redemption proceeds for more than seven days. Rule 22c-1(b) under the 1940 Act generally requires that a fund's NAV be

Generally, under the 1940 Act, funds may, but are not required to, suspend redemptions and postpone payment for redemptions already tendered for any period during which the New York Stock Exchange ("NYSE") is closed. For purposes of Section 22(e) of the 1940 Act, the staff considers the NYSE to be closed on any day when it does not open for trading for the entire day. Whether the NYSE could otherwise be considered to be closed on any given day depends on the particular facts and circumstances of the situation. When funds encounter difficulties in selling or pricing their portfolio securities due to, among other things, market breaks, trading restrictions, internal fund failures, or natural disasters, Section 22(e) does not permit funds to suspend redemptions in the absence of certain determinations by the Commission.[2]

Availability of Market Quotations

The 1940 Act requires mutual funds to value their portfolio securities by using the market value of the securities when market quotations for the securities are "readily available."[3] When market quotations are not readily available, the 1940 Act requires fund boards to determine, in good faith, the fair value of the securities. These pricing requirements are critical to ensuring that the prices at which fund shares are purchased and redeemed are fair, and do not result in dilution of shareholder interests or other harm to shareholders.[4]

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computed at least once daily, Monday through Friday, at a specific time or times as determined by the fund's board.

2 Section 22(e) also permits a fund to suspend redemptions in two other situations. First, a fund may suspend redemptions for any period during which trading on the NYSE is restricted, as determined by the Commission. Second, a fund may suspend redemptions for any period during which an emergency exists, as determined by the Commission, as a result of which it is not reasonably practicable for the fund to (1) liquidate its portfolio securities, or (2) fairly determine the value of its net assets. With respect to exigent circumstances that do not constitute an "emergency," see generally Investment Company Act Rel. No. 14459 (June 6, 1985) (discussing instances in which funds are unable to complete the mechanical process of pricing on days when pricing would normally be required under Rule 22c-1, and methods that funds may employ to address those situations).

3 Section 2(a)(41)(B) of the 1940 Act defines "value" as: (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board. This definition also is used in Rule 2a-4 under the 1940 Act as the required basis for computing periodically the current NAV of funds for the purpose of pricing their shares.

4 For example, if fund shares are overpriced, redeeming shareholders will receive a windfall at the expense of shareholders that remain in the fund, and purchasing shareholders will pay too much for the shares. Similarly, sales of shares in a fund that has undervalued its portfolio would also have dilutive effects. See Investment Trusts and Investment Companies: Hearings on

When the exchange or market on which a security is traded does not open for trading for an entire trading day, and no other market prices are available, we believe that market quotations for that security are no longer "readily available." In such instances, funds holding securities traded on the closed exchange or market must fair value price those securities.[5] For example, following September's earthquake in Taiwan, the Taiwan Stock Exchange ("TSE") was closed for a number of days. We believe that under these circumstances, market prices for securities traded on the TSE were not "readily available" and that funds holding such securities were required to use fair value prices in determining NAV.[6] In anticipation of circumstances such as these, funds should consider adopting procedures that are designed to alert the board and fund management to conditions that may necessitate fair value pricing of portfolio securities.

Fair Value Pricing

In recent years, commentators have suggested that we should provide additional or further guidance regarding pricing issues and the factors that fund boards should evaluate when fair value pricing a fund's portfolio securities. These suggestions were primarily directed at ASR Nos. 113 and 118, which were issued by the Commission at a time when financial markets were less diverse and funds had fewer investment alternatives.[7] Although we recognize the limited scope of these ASRs, we also note that they were not intended to provide comprehensive guidance to funds on how to address all pricing issues, nor were they specifically addressed to emergency or unusual situations.

S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. 136-38, 289 (1940); Accounting Series Release ("ASR") No. 219 (May 31, 1977). Thus, pricing of fund portfolio securities based upon their current values is necessary to ensure fairness among all fund shareholders.

5 We note that, in these circumstances, the determination that market quotations are no longer "readily available" does not preclude a fund's board from concluding that the most recent closing market price represents fair value. We believe that the most recent closing market prices generally should be considered, along with other appropriate factors, when determining the fair value of securities for which current market quotations are not readily available.

6 In situations such as the Taiwan earthquake, funds should pay particular attention to whether all issuers are affected by significant events similarly. For example, in the event of a natural disaster, funds that hold securities of affected issuers should, to the extent possible, make efforts to determine whether a particular issuer has been affected by that event differently from the damage inflicted generally.

7 ASR No. 113, Financial Reporting Codification (CCH) § 404.04 (Oct. 21, 1969); ASR No. 118, Financial Reporting Codification (CCH) § 404.03 (Dec. 23, 1970).

ASR Nos. 113 and 118 were intended to provide general illustrative guidance on certain valuation issues, and we believe that they continue to represent the views of the Commission.[8]

The Commission has stated that, as a general principle, the fair value of a portfolio security is the price which the fund might reasonably expect to receive upon its current sale.[9] Ascertaining fair value requires a determination of the amount that an arm's-length buyer, under the circumstances, would currently pay for the security. Fair value cannot be based on what a buyer might pay at some later time, such as when the market ultimately recognizes the security's true value as currently perceived by the portfolio manager.[10] Funds also may not fair value price portfolio securities at prices which are not achievable on a current basis on the belief that the fund would not currently need to sell those securities.[11] Thus, bond or similar funds generally may not fair value price portfolio securities at par based on the expectation that the funds will hold those securities until maturity,[12] if the funds could not receive par value upon the current sale of those securities.[13]

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[8] See, e.g., Parnassus Investments, Initial Dec. No. 131 (Sept. 3, 1998), *initial dec. final* (Oct. 8, 1998) (administrative law judge ("ALJ") finding, among other things, that the fund's directors failed to act in accordance with guidance provided in ASR Nos. 113 and 118 and failed to satisfy their good faith obligations when fair value pricing portfolio securities).

[9] See ASR Nos. 113 and 118, supra note 7; ASR No. 219, supra note 4.

[10] See Parnassus, supra note 8 (ALJ finding that a board's valuation of a portfolio security based upon what the security would be worth upon the sale of the company as a going concern, when no such offers were forthcoming, was not determined in good faith).

[11] When investors redeem fund shares, they are entitled to obtain their proportionate amount of the value of the fund's portfolio securities at the time that the transaction is effected. Similarly, when investors buy fund shares, they should not pay any more (or less) than the value of those shares at that time. See also note 4, supra.

[12] See ASR No. 219, supra note 4. In ASR No. 219, the Commission stated that it would not object if boards of certain funds determined, in good faith, that the fair value of their portfolio debt securities with remaining maturities of 60 days or less was equal to their amortized cost, unless an impairment to the creditworthiness of the issuers or other factors vitiated the accuracy of such amortized cost valuations.

[13] Unlike mutual funds, closed-end management investment companies ("closed-end funds") are not obligated to redeem fund shares at NAV. Nonetheless, closed-end fund boards are required to fair value price portfolio securities in good faith and in accordance with the same principles that apply to mutual funds. Under Section 30(e) of the 1940 Act, closed-end funds must report their NAVs to fund shareholders semi-annually. They also typically report their NAVs in newspapers weekly. In addition, closed-end funds that periodically repurchase their

This is not to say that fair value pricing is an inelastic concept. Indeed, ASR Nos. 113 and 118 recognize that no single standard exists for determining fair value in good faith. Instead, the Commission adopted a more flexible standard which requires fund 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 and to determine the method of arriving at the fair value of each such security." ASR No. 118 further states that "directors should take into account all indications of value available to them in determining the 'fair value' assigned to a particular security" (emphasis added). Whether a factor is "appropriate," and whether a particular indication of value is available, depends upon the particular facts and circumstances of the situation. Thus, during emergency situations, fund boards should evaluate as many relevant factors as they are able to under the circumstances.

ASR Nos. 113 and 118 suggest that fundamental analytical information is among the most important factors for fund boards to evaluate when fair value pricing portfolio securities. While we believe that an analysis of the value of the investment itself continues to be of primary importance in determining fair value, we also believe that in many situations fund boards may need to incorporate other, external sources of information in their fair value determinations. Information derived from world financial markets and various financial products, which can assist in establishing the value of portfolio securities or can provide indications as to the value of securities comparable to those in the portfolio, may be useful for fair value pricing in certain circumstances.

The following list of factors that fund boards may need to consider, if relevant, when fair value pricing portfolio securities is merely illustrative, and is not intended to preclude a board's consideration of any other factors. The factors include: the value of other financial instruments, including derivative securities, traded on other markets or among dealers; trading volumes on markets, exchanges, or among dealers; values of baskets of securities traded on other markets, exchanges, or among dealers; changes in interest rates; observations from financial institutions; government (domestic or foreign) actions or pronouncements; and other news events. With respect to securities traded on foreign markets, the factors also might include the value of foreign securities traded on other foreign markets, ADR trading, closed-end fund trading, foreign currency exchange

shares in reliance on Rule 23c-3 under the 1940 Act are required to compute NAV in connection with each repurchase offer. The failure to report accurate NAVs may result in the market being misled and investors buying and selling fund shares at market prices that are based, in part, on inaccurate NAVs. In addition, an adviser's receipt of advisory fees that are based on inflated NAVs may raise issues under, among other things, Sections 15(c) and 36(b) of the 1940 Act, and Section 206 of the Investment Advisers Act of 1940.

activity, and the trading prices of financial products that are tied to baskets of foreign securities, such as WEBS.[14]

We believe that a fund board, when fair value pricing portfolio securities in an emergency or other unusual situation, should evaluate the nature and duration of the event and the forces influencing the operation of the financial markets. The board also should evaluate factors relating to the event that precipitated the problem, whether the event is likely to recur, whether the effects of the event are isolated or whether they affect entire markets, countries, or regions. We believe that, at a minimum, fund boards should consider how factors, such as those listed above, or other, similar factors, to the extent relevant, may assist in fair value pricing portfolio securities.

The Board's "Good Faith" Responsibilities

The development of world financial markets and the proliferation of new financial products have both simplified and complicated a board's responsibilities when fair value pricing portfolio securities. Access to information regarding global financial markets, as well as instantaneous communications, are continually raising the amount of current and accurate information in the marketplace. New markets and products, such as those discussed above, provide alternative pricing indicators and benchmarks, which can ease the task of fair value pricing. Conversely, these new sources of information also have increased significantly the number of factors that a mutual fund board may need to evaluate when fair value pricing portfolio securities. This, in turn, provides additional challenges to fund directors, who may have to consider numerous alternatives when making complex decisions under tight time constraints.[15]

We also recognize that different fund boards, or funds in the same complex with different boards, when fair value pricing identical securities, could reasonably arrive at

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14 We understand that in connection with the extreme volatility that occurred in world financial markets in October 1997, certain funds used a variety of indicators and benchmarks to fair value price their Asian portfolio securities, including news items, the bids on baskets of securities, ADR trading, closed-end fund trading, and futures on the securities indices of certain countries.

15 One factor placing time pressure on funds to quickly determine NAV is the brief period between the time that most U.S. funds price their securities and the deadline for reporting NAV information to the NASDAQ in order to ensure that the NAVs are reported in the next day's newspapers. Although we recognize the importance of publishing this information in newspapers, this concern is secondary to ensuring that the fund's NAV is accurate. Moreover, the availability of other systems for delivering NAV information, including internet web sites and automated telephone operating systems, provides funds with alternative methods for disseminating current NAVs.

prices that were not the same, consistent with the boards' obligation to fair value price in good faith.[16] We believe that "good faith" is a flexible concept that can accommodate many different considerations, including the incorporation of a variety of sources of information. Finally, we believe that the specific actions that a mutual fund board must take in order to satisfy its good faith obligation under Section 2(a)(41) of the 1940 Act will vary, depending on the nature of the particular fund, the context in which the board must fair value price, and, importantly, the pricing procedures adopted by the board.

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.

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16 We generally believe, however, that a board could not arrive at different fair valuations for identical securities held by two or more funds that the board oversees, consistent with its good faith obligation.

When the board has vested a comparatively greater amount of discretion in fund management, or when pricing procedures are relatively vague, we believe that the board's involvement must be greater and more immediate. In these instances, a fund board may be required to evaluate how emergency conditions are affecting the fund's pricing mechanisms, whether the pricing procedures are appropriate, what inquiries fund management is making, and what factors management is considering when making valuation recommendations. Depending on the particular circumstances, the board may need to evaluate how particular portfolio securities are being priced, or, when the fund has limited or no fair value pricing procedures, authorize the specific pricing methodology used.

In any event, given that the fund's board retains oversight responsibility for the valuation of the fund's assets, the board should receive periodic reports from fund management that discuss the functioning of the valuation process and that focus on issues and valuation problems that have arisen.

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This letter addresses certain selected pricing issues and is not intended to provide comprehensive guidance on this subject. Nothing in this letter is intended to alter the guidance in ASR Nos. 113 or 118, or the general requirement that funds must use market values to value their portfolio securities when market quotations are readily available.

We will consider whether to provide additional guidance on pricing issues in the future. We would appreciate your sharing this letter with your members. If you have any questions, please contact me, Mercer Bullard, or Evan Geldzahler, at (202) 942-0660.

Very truly yours,

Douglas Scheidt

Douglas Scheidt
Associate Director and
Chief Counsel