

# Fair Valuation Series



## The Role of the Board

## **Fair Valuation Series**

<i>An Introduction to Fair Valuation</i>	Spring 2005
<i>The Role of the Board</i>	This Edition
<i>External Pricing Vendors</i>	Forthcoming

The Investment Company Institute, the Independent Directors Council, and ICI Mutual Insurance Company offer the ***Fair Valuation Series*** to assist funds and their boards in addressing securities valuations. The ***Fair Valuation Series*** is not a set of best practices. Fund boards and management, acting in good faith and exercising their reasonable business judgment, will consider many factors in developing their approach to the valuation of securities.

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# Introduction

Mutual fund boards of directors have a fundamental responsibility under the Investment Company Act of 1940 to fair value a fund's securities. Specifically, the Act provides that 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 a fund's board of directors. Unlike other responsibilities specifically given by the Act to independent directors, the responsibility for fair value determinations is assigned to the board as a whole.

The valuation of fund securities determines a fund's per share net asset value ("NAV"). Every business day, a fund must determine the value of each portfolio security it holds to calculate its NAV. The fund's NAV then is used to process purchases, redemptions, and exchanges by shareholders. Proper valuation of fund securities ensures that all transacting fund shareholders pay or receive a price that represents their proportionate share of the fund's portfolio. Improperly determined securities valuations, on the other hand, may cause adverse consequences, such as "**DILUTION**," for fund investors. Fair value pricing can protect long-term investors from dilution and other harm caused by short-term investors or arbitrageurs seeking to profit from the mispricing of a fund's securities. By the same token, eliminating arbitrage or dilution is not an appropriate reason, in and of itself, to fair value fund portfolio securities. As noted above, the Investment Company Act does not permit funds to use fair valuations unless market quotations are not "readily available."

## FAIR VALUATION SERIES

*The first installment of the Fair Valuation Series, which provides an overview of fair valuation issues, describes various events, such as markets closing before 4:00 pm and trading halts, that ordinarily would cause a fund to consider fair valuing a portfolio.*

## TERMINOLOGY: **DILUTION**

*If a fund's assets are undervalued, purchasing shareholders will receive more shares than they are entitled to upon entering the fund, diminishing the interests of the other fund investors. If a fund's assets are overvalued, redeeming shareholders will take away more than they should receive, at the expense of the remaining fund investors.*

Directors play an important role in the fair valuation process, which may include approving fund valuation policies and procedures, monitoring their implementation, and periodically reviewing the fair valuation decisions made by pricing personnel or valuation committees. While the board is ultimately responsible for the fair valuation process, that responsibility does not necessarily mean that the board itself must make fair value determinations. The specific actions that a board must take with respect to the fair valuation of securities will vary depending on, among other things, the nature of the particular fund, the context in which fair value determinations are made, and the pricing procedures adopted by the board.

According to guidance from the SEC, a board may direct members of fund management (who may or may not sit on the board) or others to make the actual fair value determinations so long as the board reviews and approves the methodology or methodologies by which fair value determinations are made, regularly reviews the appropriateness and accuracy of the valuation methodologies, and makes any necessary adjustments.

The level of director involvement in fair valuation matters varies from fund to fund and board to board. Regardless of individual levels of involvement and expertise in fair valuation issues, directors may find the following four questions useful to consider in their oversight of fair valuation determinations:

- **Are the fund's fair valuation policies and procedures appropriate in light of the fund's anticipated investments?** The SEC has indicated that, in directing fund management to make fair valuation determinations, a board of directors must approve the fund's fair valuation policies and procedures that form the basis for fair valuation determinations. Depending on the types of securities held by the fund, valuation procedures may describe specific valuation techniques and methodologies that will be used to fair value particular types of securities. For example, the valuation procedures of funds that hold foreign securities typically will address whether a “**SIGNIFICANT EVENT**” has occurred after the close of the foreign exchange or market on which the securities trade, but before the fund's NAV calculation. Policies and procedures may also include procedures for escalating difficulties or problems that may arise in the valuation process. A board's consideration of these types of issues may be important at the time the board establishes a new fund and approves the fund's fair valuation procedures.
- **Are any modifications to the policies and procedures necessary?** The SEC has stated that boards should review the methods used to fair value portfolio securities and the prices obtained through these procedures. The SEC has indicated that boards should make changes to policies and procedures when appropriate.

## TERMINOLOGY: **SIGNIFICANT EVENTS**

*Depending on the facts and circumstances involved, significant events may include: events relating to a single issuer, such as corporate announcements on earnings; events relating to an entire market sector, such as significant governmental actions (e.g., raising interest rates); natural disasters that affect securities values, such as an earthquake; or significant fluctuations in domestic or foreign markets.*

- **Do external pricing vendors engaged by the fund provide helpful information?** For certain types of securities, such as foreign equities and derivatives, some funds use external pricing vendors that offer fair valuation products or services based on quantitative models or other factors. According to the SEC staff, funds should implement appropriate measures to determine whether prices provided by vendors reflect what the funds might reasonably expect to receive upon a current sale of the securities. As part of their oversight role, directors may ask management to prepare reports that compare the prices provided by the vendors to the prices received on the sale of the securities or the securities' next available market price.
- **Is the fund's fair valuation process working effectively?** In addition to approving policies and procedures, directors play an important role in periodically monitoring the fund's fair valuation process. Monitoring can help to ensure that the fair valuation process results in the valuation of securities at prices that the fund could reasonably expect to receive upon the current sale of the securities. The SEC staff has stated that funds should regularly test their fair value prices by comparing them with values that are available from other sources (if there are any), such as actual trade prices and next-day opening prices, as well as any available quotations from external vendors.

The remainder of this installment of the *Fair Valuation Series* suggests a number of practical “dos and don’ts” intended to help directors answer these four questions and oversee an effective process for the valuation of securities.

# Fair Valuation Dos and Don'ts

## Policies and Procedures

**Do** focus on the fair valuation process and its implementation in practice.

**Don't** expect directors to determine fair values for specific portfolio securities.

As a general principle, a security's fair value is the price that the fund might reasonably expect to receive upon its current sale. To determine this price, directors, fund management, and others involved in the valuation process are required to make a good faith estimate of a security's value based on information available at the time. Estimations necessarily will vary and those involved in the valuation process are not expected to be omniscient. Nor are they expected to have chosen what, in hindsight, may appear theoretically to have been the "right" or "correct" price for a fair valued security. In fact, as the SEC has consistently pointed out, there is no single "right" or "correct" price for a fair valued security.

For these reasons, boards, their counsel, and fund management have, consistent with SEC guidance, focused their attention on developing, and following, a reasoned process for making informed valuation decisions.

The Investment Company Act states that fair values must be determined in good faith by the fund's board of directors. The SEC has stated that to comply with this responsibility, directors are not required to determine the specific fair values used by a fund. Rather, directors may entrust fair valuation decisions to individuals with suitable knowledge and expertise, subject to the board's oversight. Thus, boards typically establish a process for making informed valuation decisions and take steps to oversee that process consistently and in good faith.

**Do** approve valuation policies and procedures that are tailored to the funds you oversee.

**Don't** expect that fair valuation policies and procedures will contemplate every possible fair valuation situation.

The SEC has stated that all funds must adopt written policies and procedures governing the fair valuation of securities. These policies and procedures typically address the circumstances under which securities may be fair valued and may establish criteria for determining how to assign fair values in particular instances.

In considering valuation policies and procedures, directors, with the assistance of fund management (and counsel, if desired), may take into account the specific valuation issues that are likely to arise by virtue of the types of funds they oversee and the kinds of securities that these funds will reasonably be expected to hold. These considerations also may be a particularly important responsibility of directors when they approve the establishment of a new fund. For example, an emerging markets fund is likely to hold securities that may need to be fair valued because of the effect of threshold “**TRIGGERS**” on closing prices. Such a fund also is likely to hold securities that may need to be fair valued because of the effect of “significant events” (defined on page 3) that may occur between the time that market prices are established for those securities in their local (*i.e.*, foreign) markets and the time the fund’s NAV is calculated. Fair valuation policies and procedures that contemplate the occurrence of significant events would be appropriate for an emerging markets fund, although a significant event can also affect securities held by other types of funds.

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#### **TERMINOLOGY:** **TRIGGERS**

*Triggers signal movements in an index or security above a stated amount. For example, a fund might set a 75 basis point trigger related to movements in the S&P 500 Index.*

*This would mean that the fund would consider fair valuing securities if the S&P 500 Index closed more than 0.75 percent up or down from its previous close.*

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As another example, a fund that holds illiquid or thinly traded securities (such as micro-capitalization stocks and certain fixed-income securities) may have procedures relating to identifying and updating stale prices. By contrast, specific policies and procedures to identify and update stale prices may not be necessary for other funds, such as ones that hold securities that trade in deep, liquid markets and are listed on the New York Stock Exchange.

Fair valuation issues that are not addressed in valuation policies and procedures invariably will arise. To accommodate these situations, policies might include procedures, often called “escalation procedures,” that alert management officials not typically involved in the valuation process or certain members of the fund’s board to specific valuation issues. The need for escalation may depend on the nature of the event requiring fair valuation, the size of the position being fair valued, and the valuation’s potential effect on the fund’s NAV. As it may not always be possible to contact a specific person in a time-sensitive situation, escalation procedures often designate more than one individual from fund management or the board, who, if needed, can act on fair valuation matters.

## **Allocating Specific Duties**

**Do** consider the use of one or more valuation or pricing committees.

**Don't** expect there to be a single committee structure that will be appropriate for every board.

Depending on the number, size, and type of funds a board oversees, the board may choose to establish a committee or group, often called a “valuation committee” or “pricing committee,” which has day-to-day responsibility for fair valuation. The SEC staff has recognized that funds may use valuation committees, but has noted that the board must oversee the committee(s) and retains ultimate responsibility for valuation matters.



Practices vary widely as to the precise role and composition of valuation or pricing committees, and boards should select a committee structure based on the particular circumstances of the boards and the funds they oversee.

One common structure employs a committee made up entirely of management personnel, such as legal, compliance, fund accounting, treasury, and/or investment professionals. In selecting this structure, the board may have determined that the process of fair valuation works effectively when the full board oversees the management personnel who are knowledgeable about the fair valuation process and the securities being fair valued.

Investment professionals, for example, can be important sources of information about the value of securities. At the same time, conflict of interest concerns may be raised when investment professionals assign fair valuations that dramatically boost a fund's performance. These concerns may be heightened when the compensation of the investment professionals is based on the fund's performance. To address these potential concerns, boards may want to consider whether investment professionals responsible for managing a particular fund should have sole or primary authority for determining securities valuations for that fund.

Another structure includes a director on the valuation committee. In selecting this approach, the board may have concluded that committee participation by a director with a particular interest or experience in valuation matters may enhance board oversight of the valuation process. Directors who are contemplating this type of structure may wish to consider the differences between the roles a director would assume by virtue of being an active participant in committee decisions, on the one hand, and a reviewer of those decisions, on the other. Active participation could demand a greater time commitment and may be more likely to result in a director being named as a party in potential legal challenges relating to fair valuation.

Directors also may choose to participate in valuation committee meetings as nonmember attendees. This permits a director to oversee the process firsthand, but leaves the actual valuation determinations to others.





Another committee structure is multi-tiered, with a management pricing committee that handles daily fair valuation issues but that presents unusual or emergency fair valuation decisions to a committee made up entirely of directors. Each director on this committee may be empowered to act on behalf of the committee. This structure can facilitate board participation when time-sensitive valuation issues arise.

Regardless of the structure used, it is important that a valuation committee's membership, scope of delegated authority, and reporting obligations to the board be clearly defined. These matters often are reflected in a written charter or in the fund's valuation policies and procedures.

**Do** consider the use of external pricing vendors.

**Don't** expect that a vendor will always provide the price ultimately assigned to a security.

To assist them in meeting their fair valuation obligations, some boards, particularly those that oversee funds that invest significantly in foreign markets, have found it useful to consult external pricing vendors that offer fair valuation products and services. There is no requirement that boards use external pricing vendors, however, and the decision to use them may depend on,

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## FAIR VALUATION SERIES

*A later installment of the Fair Valuation Series will discuss external pricing vendors in more detail.*

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among other things, the particular types of securities the funds are expected to hold. Before engaging an external pricing vendor, directors may find it helpful to review background information on the vendor. This information includes, for example, consideration of the vendor's operations and internal testing procedures, emergency business continuity plans, and methodologies and information used to form its recommended valuations. Boards may request periodic presentations by the vendor, particularly if the information provided by the vendor will be an important part of the fund's fair valuation process. Boards also may request management to conduct an on-site visit of the external vendor. In addition, boards may request that management "**BACK-TEST**" a sample of the prices provided by the vendor. Boards can review and rely on management's due diligence of the pricing vendor as long as management's due diligence appears reasonably complete and thorough.

Vendors can play an important role in the fair valuation process by providing information that would be difficult for funds to develop on their own. There have been instances, however, when pricing vendors have provided improperly determined prices and, in some cases, have deviated from their stated procedures. A fund's valuation policies may include provisions for back-testing, reviewing, and, when appropriate, using different prices from those provided by external pricing vendors.

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**TERMINOLOGY:  
BACK-TESTING**

*Back-testing involves taking a sample of the prices provided by the vendor and reviewing them in light of other indicia of the value of the relevant securities, including prices received on the sale of the securities or the securities' next available market prices. Back-testing may assist in evaluating the reasonableness of using data provided by vendors.*

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## **Ongoing Oversight**

**Do** review reports from management on fair valuation.

**Don’t** stop there—follow up on any fair valuation issues that the board has raised with management.

In exercising its ongoing oversight responsibility for fair valuations, the board typically reviews, on a periodic basis, information regarding fair value determinations.

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**TERMINOLOGY:**  
**DIRECTIONAL  
CORRECTNESS**

*Directional correctness refers to whether a fair value price moved in the same direction (relative to the prior market price) as the security’s next actual market price.*

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**TERMINOLOGY:**  
**CLOSER TO THE OPEN**

*Closer to the open refers to whether a fair value price was closer to the security’s next actual market price than the prior market price, regardless of the direction.*

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Board reports relating to fair valuation may include different types of information depending on whether the fair valuations are “routine” or based on specific unusual circumstances. Routine fair valuations include those determined from the frequent application of quantitative models, such as foreign equity securities that are fair valued based on information provided by an external pricing vendor. The types of general information provided to the board may include summary back-testing data, including the “**DIRECTIONAL CORRECTNESS**” of security-level values and the degree to which the resulting valuations, taken as a whole, were “**CLOSER TO THE OPEN**.” The general information may also include an analysis of the impact fair valuations had on the fund’s NAV.

More specific information may be included in board reports for securities that are fair valued on a less routine basis. This information may include, for example, the fair value assigned to each security, the size of the holding, the effect of the fair value price on the fund’s NAV, and the rationale for the decision to fair

value. The results of back-testing analyses of securities that were fair valued also may be included in board reports to assist directors in assessing the operation of particular valuation methodologies in specific situations and over time.

Board reports also may include security-specific information for instances where management, pursuant to the fund's policies and procedures, used a price other than the one provided by the external vendor because management reasonably believed that it did not reflect the security's value. Such action on the part of management is a normal and necessary part of the valuation process, but also is an example of the type of action that, depending on its frequency, may warrant board consideration of the extent to which revisions to the fair valuation policies and procedures may be appropriate. For example, frequent use of prices other than those provided by an external vendor that increase the value of portfolio securities might indicate that a vendor's prices are not reliable. It may also be a "red flag," suggesting potential conflict of interest concerns and the need for greater board scrutiny.

Some funds also include in board reports the minutes of, or summary memoranda and other written documentation from, valuation committee meetings held during the prior period.

A board's responsibilities do not end with the review of a fair valuation report from management. SEC enforcement actions have highlighted the need for a board to follow up on fair valuation issues raised during board meetings so that fund management addresses questions or concerns expressed by directors.

**Do** periodically review fair valuation policies and procedures to make sure that they are working as intended.

**Don't** assume regulatory expectations in this area will remain static.

Fair valuation is an area in which regulatory expectations and external vendor products and services can rapidly evolve. Part of a board's responsibility is to keep abreast of these developments with the assistance of management, outside counsel, and other experts and to decide whether any developments require modifications to a fund's fair valuation policies and procedures.

The SEC requires funds to regularly review the appropriateness and accuracy of the methods used in valuing securities. Given the board's oversight responsibility for valuation, the SEC staff has stated that boards should receive periodic reports from fund management that discuss the functioning of the valuation process and any issues and valuation problems that may have arisen. Directors also may confirm with management that the fund's fair valuation prospectus disclosure is consistent with the fund's fair valuation practices.

# Overview of Enforcement Actions

From time to time, the SEC has brought enforcement actions against fund directors relating to their role in fair valuing portfolio securities. These cases may provide some guidance to directors in connection with their oversight of a fund's fair valuation process. Enforcement actions involving fund directors and the valuation process have focused on, among other things:

- Directors overlooking information indicating that prices were no longer reliable.
  - o *In one action, the SEC found that a board did not follow up on pricing issues when presented with specific information about deteriorating credit quality and questions concerning the liquidity of high-yield bonds held in a fund's portfolio.*
- Directors approving securities' prices based on valuation methodologies that were inconsistent with SEC guidance.
  - o *For example, in one case, an administrative law judge found that a thinly traded security was fair valued based on the price expected to be received in a subsequent active market, rather than the price that would be received in the current market.*
- Directors failing to consider or ignoring specific information made available to them concerning an issuer's current financial condition and future prospects.
  - o *In one case, an administrative law judge found that directors, in determining fair value, did not adequately consider the security's delisting from a stock exchange, the issuer's bankruptcy proceedings, and the issuer's consistent failure to meet management's income projections.*

- Directors continuing to rely on prices provided by a pricing service when they were given information indicating that these prices did not reflect the fair value of the securities.
  - *For example, in one case, the SEC found that directors should have instructed the fund's pricing committee to stop using a vendor's prices after the directors were advised by the fund's portfolio manager that the vendor's prices were inaccurate.*
- Directors approving fair valuation policies and procedures and considering their jobs done, rather than being alert for circumstances indicating that the procedures were not being followed.
  - *In one enforcement action, the SEC found that directors failed to follow up on their requests for information from the adviser, when the directors were on notice of problems with the prices of the fund's securities.*

# Conclusion

Given the differences among funds and boards, there is no one specific path for directors to take in the fair valuation process. Valuation is an important process, but one that has been widely recognized as “more of an art than a science.” Through effective allocation of duties and oversight, all boards can exercise good faith and protect the interests of fund shareholders in connection with fair value determinations.



## **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](http://www.sec.gov/divisions/investment.shtml).*

### **INDUSTRY GUIDANCE:**

- ICI's *An Introduction to Fair Valuation* (Spring 2005)
- ICI's White Papers: *Valuation and Liquidity Issues for Mutual Funds* (February 1997 and March 2002)

*Available to ICI members on [members.ici.org](http://members.ici.org).*

### **SEC ENFORCEMENT ACTIONS:**

- Parnassus Investments (September 3, 1998)
- Piper Capital Management (August 26, 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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