

The image features a dark blue rectangular box in the top left corner containing the text 'K&L GATES' in white, sans-serif font. The background of the slide is a complex financial chart with a grid. It includes a candlestick chart with orange bars, a line graph with a white line, and a world map composed of blue dots. A vertical yellow line is positioned in the center, and a horizontal white line is labeled '+11,000.00'.

K&L GATES

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Mutual Fund Pricing and Fair Valuation

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OVERVIEW—

- Valuation procedures are important for individual accounts, hedge funds, bank funds and registered investment companies
- Improper valuation can harm the fund and individual shareholders who are purchasing or redeeming fund shares and can also impact fee and performance calculations

OVERVIEW— THE IMPORTANCE AND THE COMPLEXITY OF VALUATION DETERMINATIONS

- Rule 22c-1 (the “forward pricing rule”) effectively requires that open-end investment companies accurately value their portfolio securities on a daily basis.
- Accuracy in the daily pricing of portfolio securities is essential.
- Valuation must be accomplished quickly, usually in the roughly 2-hour period between the NYSE close and the fund’s various reporting deadlines.
- For a long time—probably for about half of the current life span of the 1940 Act—this did not appear to be a particularly difficult or challenging endeavor.
- That, however, is no longer true for many funds.



Regulatory Framework



REGULATORY FRAMEWORK

| SOURCE | CITATION |
|--------------------------------------|--|
| Investment Company Act of 1940 | Section 2(a)(41) |
| Investment Company Act of 1940 Rules | Rule 2a-4 Rule 22c-1 Rule 38a-1 |
| SEC Commission Releases | ASR 113 ASR 118 Release No. 31166 (July 23, 2014) |
| SEC Staff Guidance | No-Action Letter (Putnam, Feb. 23, 1981) Letter to ICI (1999) Letter to ICI (2001) Pending Guidance on Valuation |
| Third Party Publications | ICI White Paper on Valuation (1997) FASB ASC 820 |

REGULATORY FRAMEWORK

Current governing law and rules view valuation issues in terms of a simple dichotomy between Market Value and Fair Value

Market Value

Securities “for which market quotations are readily available” are to be valued at “market value.”

Fair Value

- All other securities are to be valued at “fair value as determined in good faith by the board of directors.”
- The special responsibilities placed on fund boards for fair value determinations, appear to arise out of a kind of objective vs. subjective distinction:
 - The implicit notion is that market valuations are essentially objective, while fair valuations require more judgment (i.e., are more subjective) and thus require more direct board involvement.

| CONCEPT | SOURCE |
|----------------------------|--|
| Definition of Market Value | Section 2(a)(41) Rule 2a-4 ASR 118 |
| Definition of Fair Value | Section 2(a)(41) Rule 2a-4 ASR 113 ASR 118 Letter to ICI (1999) Release No. 31166 (July 23, 2014) |

REGULATORY FRAMEWORK *(CONTINUED)*

When should securities be fair valued?

- When market quotations are not readily available.
- The SEC staff has put a gloss on the words “readily available.” It does not mean only that one can readily look up the quotation; it also means that a fund can reasonably expect to receive that price in the marketplace.
- Accordingly, fair valuation should also be used when market quotations are not reliable indicators of the price the fund could expect to receive in a current sale.

REGULATORY FRAMEWORK *(CONTINUED)*

Market quotations may not be reliable if:

- sales have been infrequent;
- there is a thin market for the security; or
- the validity of the market quotations appears questionable due to (among other things):
 - an unreliable source;
 - staleness;
 - significant post-quotation events.

REGULATORY FRAMEWORK *(CONTINUED)*

The Effect of Significant Events

- A 1981 no-action letter issued to Putnam established the principle that it is appropriate to use fair value methodologies to reflect material events that occur after the closing of the relevant foreign markets but before the fund's normal pricing time.
- In 2001, the Staff effectively mandated fair valuation when a “significant event” occurs.
- But questions remain:
 - When is an event “significant?”
 - What should be the basis for a fair valuation when a significant event occurs?

REGULATORY FRAMEWORK *(CONTINUED)*

The Effect of Significant Events Continued

- Significant events affecting foreign issuers can be issuer- or industry-specific, country-wide, or even region-wide, or they can involve turbulence in world markets continuing after the close of the foreign securities exchange on which the security trades.
- As to material market movements, there are services that provide estimates of the amount by which the prices of foreign securities should be adjusted, based on a variety of historical data.
- Typically, the fund board decides in advance how much movement must occur in the markets since the time a given foreign exchange closed before the use of such a service is triggered.

REGULATORY FRAMEWORK *(CONTINUED)*

Making Fair Value Determinations

- No single correct way.
- The touchstone is whether the fair value reflects a price that the fund can reasonably expect to receive for the securities in a current sale under current market conditions.
- Methodologies and factors that may be used include:
 - multiples of earnings;
 - discount from market of similar, freely traded securities;
 - for debt instruments, yield to maturity;
 - fundamental analytical data; and
 - combinations of the foregoing.



Delegation and Controls of Valuation Process



DELEGATION AND CONTROLS

- Despite the emphasis in the 40 Act on the board's responsibility for fair valuation, delegation of day-to-day fair valuation determinations is both necessary and contemplated by SEC guidelines.
- For most funds, direct board determinations of valuations and "continuous" board review of day-to-day decisions is impractical.
- The appropriate role for the board is to act as the highest level of oversight in a multi-level system of supervision and controls.
- Effective controls are central to the discharge of the board's responsibilities.

DELEGATION AND CONTROLS *(CONTINUED)*

- The key elements of an effective control system include:
 - **Identification** of acceptable sources of regular pricing information, preferably from third parties, and verifying that those sources have internal controls for verifying the validity of the information they provide.
 - **Review and supervision** by the fund company's primary pricing group—generally fund accounting or administrators or the fund's custodian.
 - **Oversight** of the primary pricing group by a valuation committee or other supervisory personnel within fund management.

DELEGATION OF VALUATION (SOURCES)

Delegation of Valuation

ASR 113
ASR 118
Release No. 31166 (July 23, 2014)



DELEGATION AND CONTROLS *(CONTINUED)*

Oversight of Third-party Pricing Vendors

- In 2014, when the SEC adopted amendments to the rules governing money market funds, it inserted into the adopting release several pages of “guidance” on the role of fund boards in the valuation process. By its terms, this guidance was not limited to money market funds.

DELEGATION AND CONTROLS *(CONTINUED)*

2014 Release Cont'd

- The release noted that many pricing services do not simply report market prices; rather, they often provide prices that are calculated through some proprietary mechanism, such as a matrix, and/or they claim to provide “evaluated” prices.
- The release said that these prices are neither market prices nor fair values “as determined in good faith by the [fund’s] board of directors.”
- The release noted that boards can delegate aspects of the fair valuation process, but it asserted that in keeping with the board’s responsibility for fair valuation under the ’40 Act, the board may want to consider “the inputs, methods, models, and assumptions used by the pricing service,” and how those elements are affected as market conditions change.

DELEGATION AND CONTROLS *(CONTINUED)*

2014 Release Cont'd

- It noted that the board should consider the appropriateness of using evaluated prices as fair valuations of the fund's portfolio securities where the board "does not have a good faith basis for believing that the pricing service's pricing methodologies produce evaluated prices that reflect what the fund could reasonably expect to obtain for the securities in a current sale under current market conditions."
- Many fund boards have reacted to this pronouncement by inquiring more deeply into the processes, procedures and safeguards employed by the fund's outside pricing services, or – given the often complex mathematical modeling involved – consulting with others about the validity of the pricing services' approaches.



The background of the top half of the slide features a stylized world map composed of a grid of blue dots. To the right of the map is a bar chart with orange bars of varying heights. Several data points on the map and chart are highlighted with red and orange circles. The overall color palette is dominated by teal and orange.

Disclosing Valuation



The bottom half of the slide has a dark blue background with vertical lines and scattered dots in orange, red, and white. The dots are of various sizes and are connected to the lines by small circles, creating a network-like or data visualization effect.

ASC 820

Eliminating the Market Value/Fair Value Dichotomy

- FASB's ASC 820 does not reflect the same market value/fair value dichotomy that is reflected in the 1940 Act.
- Instead, ASC 820 makes clear that market quotations—whether obtained from an exchange closing price or from dealer quotes—are merely “inputs” for determining the fair value of an asset.
- ASC 820 establishes a somewhat different dichotomy—between “observable” and “unobservable” inputs.
- ASC 820 presents a hierarchy of these inputs that is substantially similar to what is called for under existing SEC guidance.

ASC 820 *(CONTINUED)*

Techniques, Approaches and Inputs

- The heart of ASC 820 is a hierarchy of valuation “inputs” that are to be used to apply the chosen valuation approach and technique.
 - Inputs are divided into two categories: observable and unobservable.
 - “Observable” inputs are based on market data obtained from sources independent of the reporting entity.
 - “Unobservable” inputs reflect the reporting entity’s own assumptions as to how market participants would approach pricing.

ASC 820 *(CONTINUED)*

The Fair Value Hierarchy

- Level 1—the highest level of inputs—comprises unadjusted quoted prices in active markets for identical assets.
- Level 2 inputs are inputs other than quoted prices that are “observable” either directly or indirectly.
- Level 3 inputs are those that are unobservable.

ASC 820 *(CONTINUED)*

Disclosure

- ASC 820 requires that entities (including mutual funds) disclose the following information at the end of each reporting period:
 - The fair values of their assets;
 - The “level” within the fair value hierarchy in which the assets fell;
 - For the assets valued using Level 3 (unobservable) inputs, a reconciliation showing beginning and ending balances broken down to show gains and losses, purchases and sales and transfers in and out of the Level 3 input category.

Sample Disclosure under ASC 820 framework

The following is a summary, categorized by Level (see Note A of Notes to Financial Statements), of inputs used to value the Fund's investments as of August 31, 2018:

Asset Valuation Inputs

(000's omitted)

| | Level 1 | Level 2 | Level 3 | Total |
|--------------------------|---------------------|-------------------|-------------|---------------------|
| Investments: | | | | |
| Common Stocks* | \$ 1,377,740 | \$ — | \$ — | \$ 1,377,740 |
| Preferred Stocks* | 1,507 | — | — | 1,507 |
| Convertible Bonds* | — | 180,758 | — | 180,758 |
| Short-Term Investments | — | 58,849 | — | 58,849 |
| Total Investments | \$ 1,379,247 | \$ 239,607 | \$ — | \$ 1,618,854 |

(a) The Schedule of Investments provides information on the industry categorization for the portfolio.

As of the year ended August 31, 2018, no securities were transferred from one level (as of August 31, 2017) to another.



Correction of Pricing Errors

CORRECTION OF PRICING ERRORS

- Errors of less than 1¢ per share are immaterial and do not require corrective action.
- Errors of 1¢ or more per share require financial adjustments in favor of the fund, but no payments to affected shareholders or reprocessing of shareholder accounts is required unless the errors amount to at least $\frac{1}{2}$ of 1% of per share NAV.
- Even here, there is a *de minimis* exception.

CORRECTION OF PRICING ERRORS

- Note the recent SEC settlement with a fund group that suffered a significant and long-lasting pricing error. The SEC required that the fund group, in determining the impact of the error and calculating the necessary cure, look beyond the intermediaries who were the record shareholders and consider the effect on the individual customers of the intermediaries who are the beneficial owners of the shares.



Other Enforcement Cases





Questions?



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