

addition, we expect policies and procedures of funds (or fund service providers) to cover certain other critical areas. In light of our recent enforcement actions against a number of fund managers and service providers,<sup>38</sup> we are taking this opportunity to review the application of these policies and procedures to several important areas of compliance with the Federal securities laws by funds and their service providers.

- *Pricing of portfolio securities and fund shares.* The Investment Company Act requires funds to sell and redeem their shares at prices based on their current net asset value, and to pay redemption proceeds promptly.<sup>39</sup> The Investment Company Act requires funds to calculate their net asset values using the market value of their portfolio securities when market quotations for those securities are “readily available,” and, when a market quotation for a portfolio security is not readily available, by using the fair value of that security, as determined in good faith by the fund’s board.<sup>40</sup> These pricing requirements are critical to ensuring fund shares are purchased and redeemed at fair prices and that shareholder interests are not diluted.

When fund shares are mispriced, short-term traders have an arbitrage opportunity they can use to exploit a fund and disadvantage the fund’s long-term investors by extracting value from the fund without assuming any significant investment risk. Mispricing

its principal underwriter from engaging in certain fraudulent, manipulative, and deceptive actions with respect to the fund); Form N-1A, Item 13(f) (17 CFR 239.15A; 274.11A) (requiring funds to disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities); 31 CFR 103.130(c) (requiring funds to develop an anti-money laundering program, which includes the establishment and implementation of “policies, procedures, and internal controls reasonably designed to prevent the mutual fund from being used for money laundering or the financing of terrorist activities and to achieve compliance with the applicable provisions of the Bank Secrecy Act and the implementing regulations thereunder”); Regulation S-P (“Privacy of Consumer Financial Information”) (17 CFR 248.30) (requiring funds to “adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information”).

<sup>38</sup> See *supra* notes 6 and 7 and accompanying text.

<sup>39</sup> Section 22(e) of the Investment Company 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. 15 U.S.C. 80a-22(e). Rule 22c-1(b) under the Act generally requires that a fund’s net asset value be computed at least once daily, Monday through Friday, at a time or times specified by the fund’s board of directors. 17 CFR 270.22c-1(b).

<sup>40</sup> Section 2(a)(41) of the Investment Company Act and rule 2a41-1 (17 CFR 270.2a41-1).

may occur with respect to portfolio securities traded on a foreign market that closes before the time at which the fund prices its shares.<sup>41</sup> If an event affecting the value of the portfolio securities occurs *after* the foreign market closes but *before* the fund prices its shares, the foreign market closing price for the portfolio security will not reflect the correct current value of those securities when the fund prices its shares. In 1984, we stated that, in these circumstances, a fund “*must*, to the best of its ability, determine the fair value of the securities, as of the time” that the fund prices its shares.<sup>42</sup> We believe that funds that fail to fair value their portfolio securities under such circumstances may violate rule 22c-1 under the Investment Company Act.<sup>43</sup> Fund directors who countenance such practices fail to comply with their statutory valuation obligations<sup>44</sup> and fail to fulfill their fiduciary obligation to protect fund shareholders. Accordingly, rule 38a-1 requires funds to adopt policies and procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security;<sup>45</sup> provide a methodology or

<sup>41</sup> Mispricing may also occur when a domestic trading market in a security closes before the time the fund prices its shares, or when market quotations for a security are not reliable because, e.g., sales have been infrequent or there is a thin market in the security. See Accounting Series Release No. 118 (Dec. 23, 1970) (35 FR 19986 (Dec. 31, 1970)). Thus, in addition to monitoring for events that may necessitate fair value pricing, funds must pay attention to circumstances that would suggest the need for using fair value pricing.

<sup>42</sup> Pricing of Redeemable Securities for Distribution, Redemption, and Repurchase, Investment Company Act Release No. 14244 (Nov. 21, 1984) (49 FR 46558 (Nov. 21, 1984)), at n. 7 (emphasis added) (proposing amendments to rule 22c-1). Subsequent to the issuance of this release, our staff has reminded funds of their fair valuation obligations. In 1999 and 2001, the Division of Investment Management issued interpretive letters elaborating on funds’ obligations under sections 2(a)(41) of the Investment Company Act and rule 22c-1 (17 CFR 270.22c-1) thereunder. Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Dec. 8, 1999) (<http://www.sec.gov/divisions/investment/guidance/tyle120899.htm>); letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (Apr. 30, 2001) (<http://www.sec.gov/divisions/investment/guidance/tyle043001.htm>).

<sup>43</sup> 17 CFR 270.22c-1.

<sup>44</sup> Section 2(a)(41) (15 U.S.C. 80a-2(a)(41)) of the Investment Company Act.

<sup>45</sup> In some cases, funds have adopted policies and procedures requiring the use of fair value pricing in circumstances when prices may be affected by events subsequent to the close of trading, but have established criteria that result in infrequent use of fair value pricing, which provides an opportunity

methodologies by which the fund determines the current fair value of the portfolio security;<sup>46</sup> and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments.<sup>47</sup>

- *Processing of fund shares.* Our rules require forward pricing of fund shares.<sup>48</sup> An investor submitting a purchase order or redemption request must receive the price next calculated after receipt of the purchase order or redemption request.<sup>49</sup> Accordingly, rule 38a-1 requires that a fund have in place procedures that segregate investor orders received before the fund prices its shares (which will receive that day’s price) from those that were received after the fund prices its shares (which will receive the following day’s price).<sup>50</sup> Because fund purchase and redemption orders are ultimately transmitted to transfer agents engaged by the fund, we have expanded the service providers covered by the rule to include transfer agents.

Many funds today have contractual provisions with transfer agents and other intermediaries that obligate those

for price arbitrage. See, e.g., Susan Lee, *The Dismal Science: The Feeling’s Not Mutual*, Wall St. J., Nov. 24, 2003, at A15. As we have stated previously, funds must fair value their portfolio securities whenever market quotations become unreliable. See *supra* note 42. The failure of a fund to establish sufficiently sensitive criteria for using fair value pricing should be recognizable in subsequent reviews of the accuracy of the prices used to compute the net asset value of the fund.

<sup>46</sup> In determining fair value, some funds use correlations between the exchange prices of foreign securities and other appropriate instruments or indicators, such as relevant indices, American Depository Receipts, and futures contracts. Software developed by vendors is today available to assist funds to determine the fair value of portfolio securities.

<sup>47</sup> In a companion release, we are proposing to amend funds’ disclosure requirements with respect to the use and the effects of fair value pricing. See Section II.B of Companion Disclosure Release, *supra* note 8.

<sup>48</sup> Rule 22c-1(a) (17 CFR 270.22c-1(a)).

<sup>49</sup> *Id.* We adopted the forward pricing requirement in 1968 to eliminate so-called “backward pricing” that permitted sales and purchases of fund shares at a stated price. We concluded that backward pricing resulted in dilution of the value of fund shares, and that it disrupted fund management by encouraging short-term trading in funds by speculators seeking to take advantage of fund prices that did not reflect the current value of the fund portfolio. Adoption of Rule 22c-1 under the Investment Company Act of 1940 Prescribing the Time Pricing of Redeemable Securities for Distribution, Redemption, and Repurchase, and Amendment of Rule 17a-3(a)(7) under the Securities Exchange Act of 1934 Requiring Dealers to Time-Stamp Orders, Investment Company Act Release No. 5519 (Oct. 16, 1968) (33 FR 16331 (Nov. 7, 1968)).

<sup>50</sup> Rule 38a-1(a)(1). In most cases, we expect these matters will be addressed by the policies and procedures of fund transfer agents. See Companion Late Trading Release, *supra* note 8, for a detailed discussion of how fund share transactions are processed by intermediaries.